

K3 Business Technology

H115 results

Investment in own IP drives growth

K3 continues to generate strong revenue growth, seeing good demand for its “ax|is” retail product combined with growth from Microsoft Dynamics NAV, SYSPRO and Sage X3 solutions. To support ongoing growth in higher-margin, own-IP licence sales, the company continues to invest in expanding its international reseller channel and in bolstering its staffing in areas where there have been resource constraints.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
06/13	63.5	4.4	14.1	1.00	16.0	0.4
06/14	72.0	6.6	18.5	1.25	12.2	0.6
06/15e	80.2	7.6	19.3	1.31	11.7	0.6
06/16e	86.3	9.6	24.4	1.38	9.3	0.6

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

H115 results: Growth across the board

K3 reported revenue growth of 21% y-o-y for H115, with gross profit growth of 12% and adjusted operating profit growth of 14% over the same period. The Retail division saw the strongest growth at 34%, although the Manufacturing & Distribution division managed respectable growth of 11%. Resource constraints have weighed on profitability, but measures taken by the company in H115 should start to have a positive impact on margins from H215.

Outlook and changes to forecasts

We have revised our forecasts to take account of the company’s new reporting format. Our revenues and normalised operating profit forecasts are substantially unchanged. In FY15, we forecast revenue growth of 17.5% for Retail and 6.2% for Manufacturing & Distribution and a normalised operating margin of 7.8% and 14.6% respectively. Due to an increase in our net debt forecasts, we have increased our net interest expense estimates for FY15 and FY16, which results in a cut to normalised EPS of 5.4% in FY15 and 3.4% in FY16.

Valuation: Trading at a discount to peers

The stock is trading on a P/E multiple of 11.7x FY15e EPS and 9.3x FY16e EPS. Sub-£200m market cap UK software stocks are trading on 21.4x current year and 15.5x next year EPS and UK IT service companies are trading on 21.5x current year and 15.4x next year EPS. K3 continues to invest in developing and supporting its own-IP solutions, including its “ax|is” solution. Combined with a focus on growing the SYSPRO and Sage businesses and selling hosting services to a larger proportion of customers, the company has the potential to grow the business on a multi-year basis. We would expect triggers for a stock re-rating to include evidence that K3 continues to win more “ax|is” contracts, expansion of the international channel, debt reduction year-on-year, and the managed services business winning customers. We believe that the stock could trade up to at least 15x FY15e EPS (289p per share).

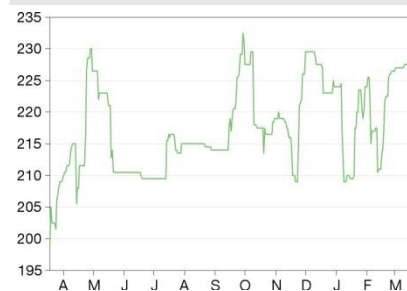
Software & comp services

18 March 2015

Price **226.0p**
Market cap **£72m**

Net debt (£m) as at end H115	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	5.6	(0.7)	19.0
Rel (local)	6.0	(8.4)	14.1
52-week high/low		232.5p	199.5p

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 events

FY15 trading update	July 2015
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Investment summary

Company description: ERP & business software specialist

K3 is a software developer and value-added channel partner; the company designs, resells and implements ERP and related business software solutions for the retail, distribution and manufacturing sectors. The group has a well-balanced business model of predictable, recurring licence income in the manufacturing software sector combined with higher growth opportunities in retail software, and offers managed services across all divisions. K3 is focused on developing its own software to enhance margins and create specialist solutions in target verticals.

Financials: Growth on all fronts

K3 saw revenue growth of 21% in H115, from a combination of 34% growth from the Retail division and 11% growth from the Manufacturing & Distribution division. Gross profit grew 12% and adjusted operating profit grew 14%. The gross margin of 50.7% (down from 54.9% a year ago) was affected by the higher mix of services revenues and the higher costs of delivery as a result of skills shortages. Measures taken in H115 to get access to the necessary skills for high-demand areas while reducing implementation costs should start to have a positive impact on gross margins from H215. Our revenue and normalised operating profit forecasts are substantially unchanged, but to reflect higher net interest expense on our higher net debt forecasts, we have made small reductions to our normalised EPS forecasts.

Exhibit 1: Changes to forecasts

	EPS			PBT			EBITDA		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2015e	20.4	19.3	(5.4)	8.0	7.6	(5.0)	11.4	11.5	0.9
2016e	25.3	24.4	(3.4)	9.9	9.6	(2.9)	13.5	13.6	0.8

Source: Edison Investment Research

Valuation: Positioned for growth

K3's share price gained 19% over the last 12 months, as the company reported good progress on selling its new "ax|is" solution and better demand in its other product lines. The stock now trades on a P/E multiple of 11.7x FY15e EPS and 9.3x FY16e EPS. Sub-£200m market cap UK software stocks are trading on 21.4x current year and 15.5x next year EPS and UK IT service companies are trading on 21.5x current year and 15.4x next year EPS. K3 continues to invest in developing and supporting its own-IP solutions, including its "ax|is" solution. Combined with a focus on growing the SYSPRO and Sage businesses and selling hosting services to a larger proportion of customers, the company has the potential to grow the business on a multi-year basis. We would expect triggers for a re-rating of the stock to include evidence that the company continues to win more "ax|is" contracts, expansion of the international channel, debt reduction year-on-year, and the managed services business winning customers. We believe that the stock could trade up to at least 15x FY15e EPS (289p per share), equivalent to an EV/sales multiple of 1.3x FY15e. K3 pays a small dividend, equivalent to a forecast yield of 0.6%.

Sensitivities: Macro, organic growth, technology

The main sensitivities or risks to our forecasts are: 1) the macro environment; 2) organic growth, which depends on the ability to hire and retain skilled staff; and 3) technology – the managed services business uses third-party data centres and could be negatively affected by service disruptions; and 4) the timing and outcome of product development (including AX for Retail) is uncertain.

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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. Since then the company has broadened its ERP offering with a number of acquisitions and moved into the managed services market.

Exhibit 2: Acquisition history

Date	Company	Details	Sector
Oct-04	Alpha Landsteinar	One of Microsoft's largest UK Dynamics resellers. Develops a version of Dynamics for retailers.	Retail
Jun-05	IEG	Resells SYSPRO, a Microsoft-based ERP solution for SME manufacturers. Adds high recurring revenue business & upgrade path for existing customers.	Manufacturing
Mar-07	MBL	SYSPRO reseller.	Manufacturing
Sep-07	Landsteinar Nederland	Dutch sister company of Alpha Landsteinar. Over 50% of revenues from franchised outlets of IKEA.	Retail
Dec-07	Index	Microsoft Dynamics AX reseller.	Manufacturing
Mar-10	DigiMIS	Specialises in hosting ERP applications, particularly SYSPRO.	Hosting
Mar-10	Pebblestone	Dutch trade & assets. Specialises in fashion retail software.	Retail
Jun-10	Pebblestone	Remainder of the business, ie IP and international sales channels.	Retail
Nov-10	Panacea	Managed services & IT solutions provider: Sage ERP & CRM, Microsoft Dynamics NAV-based distribution solutions, Dynamics CRM, SAP Business Objects and Microsoft Business Intelligence.	Managed services/ Sage
Dec-10	FD Systems	Sage 200 business.	Sage
Mar-11	Sense Enterprise Solutions	Microsoft Dynamics AX reseller.	Manufacturing
Mar-11	Clarita	Microsoft Dynamics NAV reseller.	Retail
Jul-11	Azurri	Proprietary retail solutions with substantial maintenance base.	Retail
Jul-11	FD Systems	Sage Enterprise and e-commerce solutions with substantial maintenance base.	Retail
Dec-11	Unisoft POS	Retail point-of-sale solutions for the Dutch and Scandinavian market.	Retail
Dec-11	IBS	Proprietary "make to contract" manufacturing software with substantial maintenance base.	Manufacturing
Dec-11	Retail Systems Group	Microsoft Dynamics RMS reseller focused on smaller UK & Ireland retailers.	Retail

Source: K3 Business Technology

Software solutions business model: Grow internal IP

The group supplies ERP products based on Microsoft and Sage technology and business intelligence solutions from Microsoft and QlikView (see Exhibit 3).

Exhibit 3: Product range

Microsoft-based	Sage-based	Other
SYSPRO (based on .NET)	Sage ERP 1000	Unisoft POS
Dynamics NAV	Sage Line 500	QlikView (business intelligence)
Dynamics AX	Sage 200	
Dynamics CRM	Sage ERP X3	
Dynamics RMS	Sage CRM	
Business Intelligence	Sage SalesLogix	

Source: K3 Business Technology

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 40-45% 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.

In H115, 18% of licence revenues were generated from own IP products. The table below shows how the development of proprietary IP is contributing to revenue and margin growth. K3 is organised into two divisions and reports financials on this basis. For each division, the table shows the value of software sold that is based on K3's IP and any related services, recurring revenue or hardware sales flowing directly from this licence sale. In H115, own-IP related revenues generated a gross margin of 63.9% compared to a group gross margin of 50.7%; excluding own-IP related revenues, remaining revenues generated a gross margin of 47.0%.

Exhibit 4: Own IP revenue contribution					
£m	H114	H214	H115	H115 y-o-y	H115 h-o-h
Product licence revenues – own IP	4.11	5.12	4.89	19.0%	-4.5%
Retail	2.10	3.17	2.97	41.4%	-6.3%
Manufacturing & Distribution	2.01	1.95	1.92	-4.5%	-1.5%
Product-related revenues – own IP	2.86	3.60	4.18	46.2%	16.1%
Retail	2.57	3.41	3.97	54.5%	16.4%
Manufacturing & Distribution	0.29	0.19	0.21	-27.6%	10.5%
K3 IP-related revenues/total revenues	20.2%	23.3%	21.8%		
Gross profit – own IP	4.59	6.08	5.80	26.4%	-4.6%
Retail	2.56	4.15	3.84	50.0%	-7.5%
Manufacturing & Distribution	2.03	1.93	1.96	-3.4%	1.6%
Gross margin – own IP	65.9%	69.7%	63.9%		
Retail	54.8%	63.1%	55.3%		
Manufacturing & Distribution	88.3%	90.2%	92.0%		
Group gross margin	54.9%	53.5%	50.7%		

Source: K3 Business Technology

Managed services: Cross-sell and support globally

K3 has developed its managed services business through a combination of in-house development and acquisition. In addition to offering outsourced IT support to its customer base, K3 offers application hosting to its 3,100-strong customer base, with the ability to host all products sold including own-IP solutions. K3 is focused on selling managed services across its customer base; for example, all SYSPRO contracts are sent out with a hosting option. In H115, managed services and hosting made up 10% of group revenues. K3 has an agreement with SYSPRO to provide hosting services to the wider 15,000-strong global SYSPRO customer base, providing an additional source of hosting customers.

Management

David Bolton stepped up to the CEO role in January 2014 from his role as CFO, having worked with the previous CEO since the formation of K3. Brian Davis moved into the CFO role at the same time; he had been head of finance since 2007. The company's group operations director, Andrew Hodges, previously held commercial and operations director roles in K3's Microsoft UK division.

Retail division (47% of H115 revenues)

Building IP to enhance Microsoft Dynamics technology

This division develops and sells Microsoft AX and Microsoft NAV-based solutions for the retail market. Operations are based in the UK and Holland, with three satellite offices to support overseas customers. The core offering is based around K3's "ax|is" technology. K3 started developing the IP for this solution in FY13 and in November 2013 released version one of the solution, named "ax|is fashion". In FY14 the division won nine major contracts worth £12.63m for the solution. While the initial focus is on the fashion segment of the retail market (the second largest after food retail), the company expects to use the core "ax|is" technology to develop other retail verticals. In addition to the flagship AX-based solution, K3 previously developed a retail-specific solution based on Microsoft NAV, which is targeted at small and mid-sized retailers. The company also offers complementary products such as business information, channel and point-of-sale software. All products are available for hosted or on-premise delivery.

A longstanding customer for this division is Inter IKEA Systems BV, which signed an exclusive five-year agreement at the end of FY12 for K3 to support the IKEA Master Version software used by franchisees outside the IKEA group. There are 14 franchises based in Europe, the Middle East, the Far East and Australia. Existing franchisees are encouraged to open up new stores in existing and new countries, and IKEA expects them to use K3's solution when they do so.

Expanding the partner channel

When K3 acquired Pebblestone in 2010, it gained an international reseller channel that had been selling Pebblestone's Microsoft Dynamics NAV-based IP. K3 is keen to develop a wider international partner channel for "ax|is" and other K3 own-IP products. In H115, the division saw its first "ax|is" fashion sales through the partner channel in Europe (Roberto Verino), Australasia (Jeanswest) and North America (Vince Holding Corp). Total channel sales amounted to £2.26m in H115 (+78% y-o-y).

In November 2014, K3 was accredited Microsoft's first GISV (global independent software vendor) partner for the fashion retail sector, and is one of only 25 GISVs across all sectors. This gives K3 access to technical, sales and marketing support from Microsoft.

Review of current trading

See Exhibit 6 on page 7 for a detailed breakdown of divisional revenues and profitability. The division saw y-o-y revenue growth of 34%, supported by sales of the "ax|is" product, existing NAV solutions and work from Inter IKEA and its franchisees. The company experienced deferred software sales in Holland, where the fashion and retail market is still depressed. Recurring revenues saw strong growth of 40% y-o-y, reflecting the growing level of maintenance contracts as "ax|is" licences are implemented. Recurring revenues were down 9% h-o-h, reflecting seasonality in licence renewals. Software revenues grew 20% y-o-y, and related services grew 38% as projects were underway to implement recent licence wins.

Gross profit grew 24% y-o-y, although the gross margin fell from 47.0% to 43.6% over the period, reflecting the higher mix of service revenues. The cost of delivering on AX projects was affected by the difficulty in hiring qualified staff, resulting in a services gross margin of 21%. The company highlighted in September that it had taken action to mitigate this by shifting some work to near-shore resources and increasing in-house training. These actions should start to have a positive impact on the gross margin from H215.

The business received new orders worth £6.8m in H115 (-32% y-o-y), in line with expectations. Orders included an AX solution for Countrywide Farmers and a NAV solution for Wasabi.

Outlook

The retail business had a new deal pipeline worth £26.3m at the end of H115m, down from £38.0m a year ago, reflecting the high level of order wins over the year. The business sees a good level of contracted services revenues for H215.

Manufacturing & Distribution division (53% of H115 revenues)

This division supplies SYSPRO, Sage and Microsoft Dynamics AX and NAV solutions to c 1,000 manufacturing customers and c 700 distribution customers. As in the retail division, K3 develops its own IP to enhance the SYSPRO and Microsoft Dynamics functionality. Own-IP products include advanced planning and scheduling, warehouse management, pallet management, data integration and payroll/HR. The division offers hosting and managed services for all solutions and, as described on page 4, has launched a cloud service for SYSPRO.

K3 is SYSPRO's exclusive partner in the UK and Europe. SYSPRO is a Microsoft.NET-based ERP solution developed for the manufacturing sector. This business generates a high level of licence and support renewals in the second half of each calendar year (ie K3's H1).

K3 is one of Sage's largest partners in the UK, and is the largest reseller of Sage X3. Sage X3 is Sage's most advanced ERP offering and is targeted at mid-market companies.

All hosting and managed services are reported in this division; we note that c 25% of revenues are generated from Retail customers.

Review of current trading

Divisional revenues grew 11% y-o-y. Software sales grew 54% y-o-y, with growth in Sage sales, two large order wins for Microsoft Dynamics AX and NAV, and continued strong performance from SYSPRO. Services revenues grew 16% y-o-y. Recurring revenues were flat y-o-y; while the SYSPRO business remained strong (98% renewal rate maintained), the business saw competition in the lower-tier Sage offerings, particularly Sage 200, resulting in higher customer churn. Hosting and managed services revenues grew 2% y-o-y, although the company expects to see better growth in H215 as previously deferred projects are scheduled to start over the next 12-18 months.

Gross profit grew 4% y-o-y, although gross margin declined from 60.7% to 56.9% over the year. For services projects underway in H115, resources in key skill areas were heavily utilised and the company experienced skill shortages in Microsoft Dynamics AX and Sage X3, resulting in higher costs of delivery. The business also invested in personnel to support future growth, particularly for SYSPRO, and this had a negative effect at the adjusted operating profit level, which reduced 4% y-o-y.

Outlook

The business received new orders worth £5.5m in H115 (+155% y-o-y) and had a pipeline worth £29.0m at the end of H115, up 22% y-o-y. The division is introducing new products such as SYSPRO Business Live (cloud-based SYSPRO) and an upgrade of K3 Advantage, the Microsoft Dynamics NAV product for distribution, to NAV 2015. The division also signed new SYSPRO channel partners in three European countries.

Financials

Review of H115 results

Exhibit 5: H115 results highlights			
£'000	H114	H115	Change
Revenues	34,469	41,669	20.9%
Normalised* operating profit	3,622	4,117	13.7%
Normalised* operating margin	10.5%	9.9%	-0.6%
Reported operating profit	1,319	2,344	77.7%
Normalised* profit before tax	3,178	3,566	12.2%
Normalised* net income	2,411	2,638	9.4%
Reported net income	894	1,219	36.4%
Reported EPS (p)	2.9	3.9	34.5%
Normalised* EPS (p)	7.6	8.2	7.6%
Net debt	9,906	12,074	21.9%

Source: K3 Business Technology, Edison Investment Research. Note: *Normalised: before amortisation of acquired intangibles, exceptional items and share-based payments.

Exhibit 6: Revenues by division and type, H114-H115					
£m	H114	H214	H115	H115 y-o-y	H115 h-o-h
Revenues					
Software	5.69	7.20	7.62	33.9%	5.8%
Retail	3.39	3.23	4.08	20.4%	26.3%
Manufacturing & distribution	2.30	3.97	3.54	53.9%	-10.8%
Services	9.19	10.64	11.93	29.8%	12.1%
Retail	5.47	6.69	7.63	39.5%	14.1%
Manufacturing & distribution	3.72	3.95	4.30	15.6%	8.9%
Recurring revenues	17.91	17.50	19.84	10.8%	13.4%
Retail	4.85	7.47	6.78	39.8%	-9.2%
Manufacturing & distribution	13.06	10.03	13.06	0.0%	30.2%
Hardware & other revenues	1.67	2.15	2.28	36.5%	6.0%
Retail	0.96	1.07	1.14	18.8%	6.5%
Manufacturing & distribution	0.71	1.08	1.14	60.6%	5.6%
Total revenues	34.46	37.49	41.67	20.9%	11.1%
Retail	14.67	18.46	19.63	33.8%	6.3%
Manufacturing & distribution	19.79	19.03	22.04	11.4%	15.8%
Gross profit	18.92	20.04	21.11	11.6%	5.3%
Retail	6.90	9.54	8.56	24.1%	-10.3%
Manufacturing & distribution	12.02	10.5	12.55	4.4%	19.5%
Gross margin	54.9%	53.5%	50.7%		
Retail	47.0%	51.7%	43.6%		
Manufacturing & distribution	60.7%	55.2%	56.9%		
Operating costs	15.31	16.37	17.00	11.0%	3.8%
Retail	6.43	7.81	7.5	16.6%	-4.0%
Manufacturing & distribution	8.48	8.55	9.15	7.9%	7.0%
Head office	0.40	0.01	0.35	-12.5%	N/A
Adjusted* operating profit	3.61	3.69	4.11	13.9%	11.4%
Retail	0.47	1.73	1.06	125.5%	-38.7%
Manufacturing & distribution	3.54	1.95	3.4	-4.0%	74.4%
Head office	-0.40	0.01	-0.35	-12.5%	N/A
Adjusted* operating margin	10.5%	9.8%	9.9%		
Retail	3.2%	9.4%	5.4%		
Manufacturing & distribution	17.9%	10.2%	15.4%		

Source: K3 Business Technology. Note: *K3 reports adjusted operating profit as before amortisation of acquired intangibles and exceptional items, but after share-based payments.

K3 reported 20.9% y-o-y revenue growth in H115 (see Exhibit 4 for group performance, Exhibit 6 for performance by division). Retail revenues grew 33.8% and Manufacturing & Distribution grew 11.4%. Group gross profit grew at a lower rate of 11.6%, due to the combination of a slightly higher proportion of services revenues and the impact of higher staffing costs in both divisions. Normalised operating profit grew by 13.9%, although the operating margin declined 60bp over the same period,

for the reasons described above, and as the company invested in additional resource for SYSPRO. The company reported an exceptional charge of £158k for reorganisation of the group's structure and management changes.

In August 2014, the company renegotiated its debt facility on similar terms to the previous facility, with debt due for repayment in August 2017. At the end of H115, the company reported gross debt of £13.4m (£3.0m short-term, £10.4m long-term). As the company received a high level of orders close to the period end (generating £9m in revenues in December 2014), working capital was higher than expected, resulting in higher net debt on a year-on-year basis. We note that net debt was 11.4% lower than at the end of FY14.

Outlook and changes to forecasts

The company continues to focus on extending its own IP across its core product offerings, supporting multi-year growth in revenues, recurring revenues and gross margins. The development of the international reseller channel will be key to maximising the revenue opportunity. The company is addressing skills-related challenges, which should start to have a positive effect on the cost of implementations.

We have left our revenue and operating profit forecasts substantially unchanged; our forecasts now reflect the new divisional structure. We have increased our net interest expense forecast by £400k in FY15 and £300k in FY16 years to reflect the higher forecast levels of net debt. This results in cuts to our normalised EPS forecasts of 5.4% in FY15 and 3.4% in FY16.

Based on the level of capex in H115, we have increased our forecasts for capitalised development costs from £2.8m to £3.5m in FY15 and from £2.8m to £3.0m in FY16. We forecast that amortisation of capitalised development costs is moving closer to the amount capitalised each year, increasing from £1.6m in FY14 to £2.0m in FY15 and £2.3m in FY16.

Our net debt forecasts for end FY15 and end FY16 increase to reflect higher interest expense and higher capitalised development costs. We forecast net debt/EBITDA of 1.1x at the end of FY15 falling to 0.7x by the end of FY16. The table below shows the impact of the changes to our estimates.

Exhibit 7: Changes to forecasts								
£m	Old	New		Old	New		Growth	
	FY15e	FY15e	Change	FY16e	FY16e	Change	FY15e	FY16e
Retail		38.9			42.4		17.5%	8.9%
Manufacturing & distribution		41.2			43.9		6.2%	6.3%
Revenues	79.71	80.17	0.6%	84.20	86.25	2.4%	11.4%	7.6%
							Op. margin	
Retail		3.05			4.43		7.8%	10.5%
Manufacturing & distribution		6.04			6.62		14.6%	15.1%
Head office costs		(0.53)			(0.64)			
Normalised operating profit	8.56	8.56	0.0%	10.40	10.41	0.1%		
Operating margin	10.7%	10.7%	-0.1%	12.4%	12.1%	-0.3%		
Normalised PBT	7,956	7,560	-5.0%	9,902	9,614	-2.9%		
Normalised net income	6,522	6,192	-5.1%	8,114	7,864	-3.1%		
Reported EPS (p)	11.8	10.8	-9.0%	17.1	16.8	-2.0%		
Normalised EPS (p)	20.4	19.3	-5.4%	25.3	24.4	-3.4%		
Net debt	10,657	12,349	15.9%	6,275	8,867	41.3%		

Source: Edison Investment Research

Valuation

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lines. The stock now trades on a P/E multiple of 11.7x FY15e EPS and 9.3x FY16e EPS. Sub-£200m market cap UK software stocks are trading on 21.4x current year and 15.5x next year EPS and UK IT service companies are trading on 21.5x current year and 15.4x next year EPS. K3 continues to invest in developing and supporting its own-IP solutions, including its “ax|is” solution. Combined with a focus on growing the SYSPRO and Sage businesses and selling hosting services to a larger proportion of customers, the company has the potential to grow the business on a multi-year basis.

We would expect triggers for a re-rating of the stock to include evidence that the company continues to win more “ax|is” contracts, expansion of the international channel, debt reduction year-on-year, and the managed services business winning customers. We believe that the stock could trade up to at least 15x FY15e EPS (289p per share), equivalent to an EV/sales multiple of 1.3x FY15e. K3 pays a small dividend, equivalent to a forecast yield of 0.6%.

Sensitivities

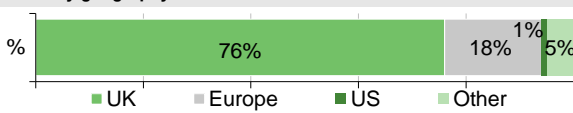
The main factors influencing our forecasts and the share price are:

- **Macro environment:** consumer spending has an impact on retail and manufacturing demand;
- **Organic growth:** in all divisions, organic growth depends on the ability to hire and retain skilled staff. This is particularly evident in the Microsoft AX business, where the company has hired and is training AX resources to meet customer demand for the new “ax|is” solution; and
- **Technology:** the managed services business relies on third-party data centres – any breach in security or service disruption could influence customer demand. The outcome in terms of timing and uptake of new product development is uncertain.

Exhibit 8: Financial summary

	£'000s	2012	2013	2014	2015e	2016e
Year end 30 June		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		67,961	63,513	71,950	80,170	86,250
Cost of Sales		(28,491)	(30,375)	(32,990)	(38,660)	(41,296)
Gross Profit		39,470	33,138	38,960	41,510	44,954
EBITDA		12,942	7,261	9,861	11,460	13,614
Operating Profit (before am of acq. Intang. and except.)		11,405	5,164	7,328	8,560	10,414
Amortisation of acquired intangibles		(3,586)	(3,182)	(2,989)	(3,000)	(3,000)
Share-based payments		(72)	(70)	(27)	(20)	(30)
Other		(395)	(727)	(1,722)	(158)	0
Operating Profit		7,352	1,185	2,590	5,382	7,384
Net Interest		(1,309)	(723)	(705)	(1,000)	(800)
Profit Before Tax (norm)		10,096	4,441	6,623	7,560	9,614
Profit Before Tax (FRS 3)		6,043	462	1,885	4,382	6,584
Tax		(319)	780	675	(968)	(1,250)
Profit After Tax (norm)		8,591	4,165	5,874	6,192	7,864
Profit After Tax (FRS 3)		5,724	1,242	2,560	3,414	5,334
Average Number of Shares Outstanding (m)		28.2	29.2	31.4	31.7	31.8
EPS - normalised (p)		30.4	14.3	18.7	19.6	24.8
EPS - normalised fully diluted (p)		29.7	14.1	18.5	19.3	24.4
EPS - FRS 3 (p)		20.3	4.3	8.1	10.8	16.8
Dividend per share (p)		1.00	1.00	1.25	1.31	1.38
Gross Margin (%)		58.1	52.2	54.1	51.8	52.1
EBITDA Margin (%)		19.0	11.4	13.7	14.3	15.8
Operating Margin (before GW and except.) (%)		16.8	8.1	10.2	10.7	12.1
BALANCE SHEET						
Fixed Assets		68,325	69,398	67,067	65,081	62,431
Intangible Assets		21,255	21,040	20,040	18,540	16,240
Tangible Assets		2,722	2,927	2,439	2,089	1,739
Goodwill		43,540	44,610	43,952	43,952	43,952
Other		808	821	636	500	500
Current Assets		32,418	25,523	29,535	33,819	36,475
Stocks		0	0	0	0	0
Debtors		30,322	25,251	28,888	32,507	35,682
Cash		2,096	272	647	1,312	794
Current Liabilities		(48,043)	(39,272)	(40,278)	(30,101)	(28,710)
Creditors		(8,797)	(5,842)	(7,218)	(8,041)	(8,650)
Other Creditors		(21,468)	(19,379)	(18,799)	(18,799)	(18,799)
Short term borrowings		(17,778)	(14,051)	(14,261)	(3,261)	(1,261)
Long Term Liabilities		(5,797)	(4,524)	(3,719)	(14,105)	(12,105)
Long term borrowings		0	(32)	(14)	(10,400)	(8,400)
Other long term liabilities		(5,797)	(4,492)	(3,705)	(3,705)	(3,705)
Net Assets		46,903	51,125	52,605	54,694	58,092
CASH FLOW						
Operating Cash Flow		7,284	8,022	5,352	8,506	9,998
Net Interest		(839)	(820)	(848)	(1,000)	(800)
Tax		(1,312)	(1,217)	290	(1,368)	(1,750)
Capex		(3,160)	(4,613)	(4,487)	(4,050)	(3,550)
Acquisitions/disposals		(7,132)	(1,917)	(129)	(458)	0
Financing		5,026	2,677	277	44	0
Dividends		(214)	(286)	(316)	(395)	(417)
Net Cash Flow		(347)	1,846	139	1,279	3,482
Opening net debt/(cash)		15,486	15,682	13,811	13,628	12,349
HP finance leases initiated		0	0	0	0	0
Other		151	25	44	0	0
Closing net debt/(cash)		15,682	13,811	13,628	12,349	8,867

Source: K3 Business Technology, Edison Investment Research

Contact details		Revenue by geography					
Baltimore House, 50 Kansas Avenue, Manchester M50 2GL +44 (0)161 876 4498 www.k3btg.com							
CAGR metrics	Profitability metrics	Balance sheet metrics	Sensitivities evaluation				
EPS 12-16e	-4.8%	ROCE 15e	11.2%	Gearing 15e	22.6%	Litigation/regulatory	○
EPS 14-16e	14.9%	Avg ROCE 12-16e	13.1%	Interest cover 15e	8.6	Pensions	○
EBITDA 12-16e	1.3%	ROE 15e	11.3%	CA/CL 15e	1.1	Currency	●
EBITDA 14-16e	17.5%	Gross margin 15e	51.8%	Stock days 15e	0.0	Stock overhang	●
Sales 12-16e	6.1%	Operating margin 15e	10.7%	Debtor days 15e	148.0	Interest rates	●
Sales 14-16e	9.5%	Gr mgn / Op mgn 15e	4.8x	Creditor days 15e	139.1	Oil/commodity prices	○
Management team							
CEO: David Bolton		CFO: Brian Davis					
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. He held the role of CFO from 1998 before moving into the CEO role in January 2014.		Brian joined K3 in 2007 as group head of finance and was appointed to the CFO role in January 2014. Before K3, he worked at several listed companies in financial and commercial roles (including as group financial controller and company secretary at Spring Group) and before that spent 10 years at Arthur Andersen. He is an FCA.					
Chairman: Lars-Olof Norell							
Lars-Olof was appointed to the role of interim chairman in November 2014. He has extensive experience of the technology sector, having spent close to 30 years working at Capgemini. He continues to advise companies on their growth strategies and technology solutions.							
Principal shareholders			(%)				
PJ Claesson			19.0				
Kestrel Partners LLP			14.5				
Hargreave Hale			13.9				
Investec Asset Management			5.6				
Axxion SA			5.3				
Herald Investment Management			4.4				
Seneca Investment Managers			4.3				
Milton Asset Management			4.3				
David Bolton			3.1				
Companies named in this report							
Microsoft (MSFT), Sage (SGE)							

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