K3 Business Technology

FY16 results

Retail provides the growth engine

Software & comp services

K3's FY16 results confirmed that the Retail business continues to make good progress with strong order intake at year-end despite the Brexit vote. Performance in certain parts of the Manufacturing & Distribution business was disappointing; action has been taken to reinvigorate sales in these areas. With a strong pipeline entering FY17, K3 is in a good position to generate growth in revenues, profitability and cash flows.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
06/15	83.4	7.2	19.1	1.50	18.2	0.4
06/16	89.2	8.8	23.0	1.75	15.1	0.5
06/17e	97.2	11.3	25.3	1.93	13.8	0.6
06/18e	101.0	12.3	27.5	2.12	12.7	0.6

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

Retail strength offset by Sage weakness

K3 reported FY16 revenue growth of 6.9%, 1.9% ahead of our forecast helped by strong order intake for the Retail business in H216. While group gross profit and gross margin exceeded our forecasts, the Sage business acted as a drag on profitability and higher than expected operating expenses (in part because one customer went into administration close to year-end) resulted in adjusted operating profit 6.7% below our forecast. Normalised EPS, however, was only 1.1% below our forecast helped by lower interest and tax charges. CEO David Bolton has announced that he is moving to the role of executive chairman and the search for a new CEO is underway.

Outlook and changes to forecasts

We have revised our forecasts to take account of the relative performances of the two divisions, factoring in stronger growth for Retail and slower growth for Manufacturing & Distribution as well as adding in the recent Merac acquisition. While we raise our FY17 revenue forecast by 1.7%, higher ongoing operating expenses result in a 3.5% cut to our adjusted profit and 3.7% cut to our normalised EPS forecast (9.7% EPS growth). We introduce a forecast for 8.7% EPS growth in FY18. We forecast a £4.4m reduction in net debt in FY17 moving to a net cash position by the end of FY18.

Valuation: Trading at a discount to peers

K3 is trading on a P/E multiple of 13.8x FY17e normalised EPS and 12.7x FY18e compared to small-cap UK software and IT services stocks trading on an average 19.8x current year and 16.8x next year EPS. K3 continues to invest in developing and supporting its own-IP solutions and building out its partner channel. Combined with a focus on selling hosting services to a larger proportion of customers, the company has the potential to grow the business on a multi-year basis. Continued evidence of consistent revenue growth and margin improvement should help to reduce the discount to peers.

14 September 2016

Price	**348.0p**
Market cap	**£125m**
	€1.17:£1
Net debt (£m) at end FY16	8.9
Shares in issue	36.0m
Free float	78%
Code	KBT
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	12.3	(2.7)	25.4
Rel (local)	15.9	(11.1)	16.1
52-week high/low		373.50p	277.50p

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	24 November 2016

Analysts

Katherine Thompson +44 (0)20 3077 5730

Dan Ridsdale +44 (0)20 3077 5729

tech@edisongroup.com

Edison profile page

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

Review of FY16 results

K3 reported group revenue growth of 6.9%, 1.9% ahead of our forecast. On a divisional basis, Retail revenues came in 6.2% ahead of our forecast whereas Manufacturing & Distribution was 2.1% below. The company had to write off revenues relating to a major customer, My Local, which went into administration at the end of FY16. We understand this comprised mainly hosting and maintenance revenues, with the greatest impact on the Retail division and a smaller effect on Manufacturing & Distribution. Recurring revenues grew 4% y-o-y to make up 46.7% of total revenues, slightly down from 47.8% in FY15.

Group gross profit of £48.5m was 2.5% ahead of our forecast whereas normalised operating profit was 6.7% below. The My Local bad debt, incurred at the end of H216, made up a large percentage of the operating expense overrun. In addition, the company bolstered its legal team and other senior management, resulting in higher than expected head office costs. The net interest expense of £701k was lower than our £780k forecast, and the tax rate came in below our forecast (13.3% versus 18.0% on a normalised basis), resulting in normalised EPS only 1.1% below our forecast. As previously flagged in the July trading update, net debt was higher than our forecast due to a combination of currency (c £0.6m impact), the My Local write-off and licence deals signed at the end of the period. In addition, total capex (tangibles plus capitalised development costs) came in at £5.6m compared to our £4.7m forecast.

The company announced a final dividend of 1.75p, +16.7% y-o-y and ahead of our 1.65p forecast.

Exhibit 1: Summary financials

£m	FY15	FY16	FY16	% difference	% y-o-y
Retail revenues	39.7	42.3	44.9	6.2	13.0
Manufacturing & distribution revenues	43.7	45.2	44.3	-2.1	1.3
Total revenues	83.43	87.50	89.18	1.9	6.9
Retail	3.51	5.25	6.05	15.1	72.4
Manufacturing & distribution	5.12	5.50	4.28	-22.2	(16.4)
Head office costs	(0.46)	(0.54)	(0.80)	48.5	73.9
Normalised* operating profit	8.17	10.22	9.53	-6.7	16.6
Operating margin	*9.8%*	*11.7%*	*10.7%*	*-1.0*	*0.9*
Normalised PBT	7.24	9.44	8.83	-6.4	23.9
Normalised net income	6.16	7.74	7.65	-1.1	24.1
Reported EPS (p)	10.9	14.0	12.6	-9.4	15.6
Normalised EPS (p)	19.1	23.3	23.0	-1.3	20.4
Net debt	12.08	5.77	8.88	54.0	(26.5)

Source: K3 Business Technology Group, Edison Investment Research. Note: *Normalised profitability measures exclude exceptionals, share-based payments and amortisation of acquired intangibles.

Exhibit 2: Own-IP related revenues

£m	H115	H215	H116	H216	% y-o-y	% h-o-h
Product licence revenues	4.54	4.20	4.89	5.87	39.8	20.0
Retail	2.62	2.88	3.13	4.21	46.2	34.5
Manufacturing & distribution	1.92	1.32	1.76	1.66	25.8	-5.7
Product-related revenues	4.53	4.62	4.67	5.84	26.4	25.1
Retail	4.32	4.08	4.49	5.64	38.2	25.6
Manufacturing & distribution	0.21	0.54	0.18	0.20	-63.0	11.1
Gross profit	5.8	5.92	6.27	7.81	31.9	24.6
Retail	3.84	4.18	4.47	6.10	45.9	36.5
Manufacturing & distribution	1.96	1.74	1.80	1.71	-1.7	-5.0
Gross margin (%)	*63.9*	*67.1*	*65.6*	*66.7*	*-0.4*	*1.1*
Retail	*55.3*	*60.1*	*58.7*	*61.9*	*1.9*	*3.3*
Manufacturing & distribution	*92.0*	*93.5*	*92.8*	*91.9*	*-1.6*	*-0.8*
K3 IP-related revenues/total revenues (%)	*21.8*	*21.1*	*22.6*	*25.0*	*3.9*	*2.4*

Source: K3 Business Technology

The company is gradually increasing the proportion of own-IP related sales (ie the combination of sales of licences based on K3's IP plus related revenues). As this is higher margin, this should help drive the group gross margin up over time. Efforts to reduce the cost of implementation in the Retail division are also helping to bring up the Retail own-IP gross margins.

Exhibit 3: K3 divisional performance

£m	FY16a	FY16e	% difference
Revenues			
Software	16.23	14.99	8.3
Retail	10.34	8.90	16.2
Manufacturing & distribution	5.89	6.09	-3.3
Services	25.74	26.23	-1.9
Retail	14.52	15.43	-5.9
Manufacturing & distribution	11.22	10.80	3.9
Recurring revenues	41.62	40.47	2.8
Retail	16.74	14.40	16.3
Manufacturing & distribution	24.88	26.07	-4.6
Hardware & other revenues	5.59	4.85	15.3
Retail	3.32	2.59	28.2
Manufacturing & distribution	2.27	2.26	0.4
Total revenues	89.18	87.50	1.9
Retail	44.92	42.29	6.2
Manufacturing & distribution	44.26	45.22	-2.1
Gross profit	48.54	47.38	2.5
Retail	23.36	21.20	10.2
Manufacturing & distribution	25.18	26.17	-3.8
Gross margin (%)	*54.4*	*54.1*	*0.3*
Retail	*52.0*	*50.1*	*1.9*
Manufacturing & distribution	*56.9*	*57.9*	*-1.0*
Operating costs	39.04	37.19	5.0
Retail	17.31	15.95	8.5
Manufacturing & distribution	20.90	20.67	1.1
Head office	0.83	0.57	45.6
Adjusted operating profit*	9.50	10.19	-6.7
Retail	6.05	5.25	15.1
Manufacturing & distribution	4.28	5.50	-22.2
Head office	-0.83	-0.57	45.6
Adjusted operating margin (%)	*10.7*	*11.6*	*-1.0*
Retail	*13.5*	*12.4*	*1.0*
Manufacturing & distribution	*9.7*	*12.2*	*-2.5*

Source: K3 Business Technology. Note: *Adjusted operating profit excludes exceptionals and amortisation of acquired intangibles.

Retail

The division saw strong growth of 13.0% in FY16. Excluding the £0.8m contribution from DdD (two months' worth), revenues grew 11.0%. This is after writing off revenues from the failure of My Local. Software licence sales were particularly strong, up 44.8% y-o-y. H216 licence sales were up 90.8% y-o-y and 29.8% h-o-h, with several major deals signed in the period. The division also continues to see a steady flow of work from the Ikea franchisees as they roll-out and upgrade stores.

Recurring revenues increased 13% to make up 37% of revenues (flat versus FY15). Several customers have signed extended software licence enhancements ahead of Microsoft's planned licensing structure changes.

Services revenues decreased 4% after the completion of several contracts that used high levels of contractors. The company has worked to bring the cost of implementation down and has built more automation into the process, resulting in improved gross margins of 27% for this part of the business (up from 24%).

The division received orders worth £21.0m in FY16, compared to £11.3m in FY15. Larger contracts included orders from Bonmarché, Sue Ryder, Fortnum & Mason and Ann Summers. The channel partner network generated orders from 27 customers (eight for ax│is Fashion), including the contracts with TriStyle, KLiNGEL and Lacoste that were previously announced. Orders through the channel totalled £2.43m, compared to £1.60m in FY15.

Adjusted operating profit of £6.05m (13.5% margin) came in 15% ahead of our forecast despite the loss generated from the My Local write-off.

Outlook

The new deal pipeline has expanded by 40% y-o-y and 70% h-o-h to £44.9m, including £4.6m via channel partners. Management continues to see North America as a good opportunity for new orders and is building a team with sales and pre-sales capability in addition to developing its channel partner strategy there.

Manufacturing & Distribution

This division saw mixed performance, with revenues increasing by only 1.3% to £44.3m (2.1% below our forecast) and adjusted operating profit coming in 22% below our forecast to generate a margin of 9.7% compared to 11.7% the prior year. We note that the Starcom acquisition added revenues of £2.5m and adjusted operating profit of £0.25m y-o-y. The SYSPRO business saw good levels of renewals and upgrades to new customers but saw disappointing levels of new business in H2. The expected improvement in the Sage business did not materialise in H216, resulting in a £1m negative impact on profitability y-o-y. The cloud hosting and managed services business has made good progress in the year, ending the year with a contracted subscription run rate of £8.5m (£6.5m from hosting), up from £8.0m (£6.0m from hosting) at the end of FY15 despite losing the My Local business.

Software licence revenues declined 12% y-o-y, mainly due to lower sales of Sage and CRM solutions. This conversely had a positive impact on licence gross margins, increasing to 58.4% from 54.9% a year ago. Services revenues rose 15% y-o-y reflecting implementation activity for Microsoft Dynamics, CRM and hosting. New orders increased 43% y-o-y to £14.3m, as the Microsoft Dynamics AX and NAV had a strong H2.

Outlook

At the end of H216, action was taken to refresh the SYSPRO new business sales team and changes made to the Sage sales team to improve closure rates, which should result in improved levels of new business in FY17. The new business pipeline stood at £31.2m at the end of FY16, up 4.7% y-o-y and 3.3% h-o-h.

Outlook and changes to forecasts

The company is focused on developing and selling its own-IP product, and continues to cultivate its partner channel. The strong order book and new business pipeline support growth in FY17. We note that the gradual shift towards consumption-based licensing models will extend the period over which profits are recognised and cash is received, although the precise impact is difficult to forecast owing to the wide variety of contract types.

We summarise below the changes to our forecasts. We expect the company to move to a net cash position by the end of FY18. The main changes in our forecasts arise from:

- Revenues: stronger performance from Retail and weaker performance in Manufacturing & Distribution plus adding in Merac from the beginning of July.

- Higher operating costs reflecting the increases described above.
- Higher working capital.
- Higher dividend forecasts for FY17 and FY18 (assume 10% growth in both years).

Exhibit 4: Changes to forecasts

£m	Old	New	Change	New	Growth (%)	
	FY17e	FY17e	(%)	FY18e	FY17e	FY18e
Retail	48.4	50.4	4.1	52.9	12.2	5.0
Manufacturing & distribution	47.2	46.8	-0.8	48.1	5.7	2.7
Revenues	95.61	97.20	1.7	100.99	9.0	3.9
					Margins (%)	
Retail	6.44	7.41	15.1	7.98	14.7	15.1
Manufacturing & distribution	6.29	5.21	-17.2	5.52	11.1	11.5
Head office costs	(0.58)	(0.89)	53.4	(0.93)		
Normalised operating profit	12.15	11.73	-3.5	12.57		
Operating margin	12.7%	12.1%	-0.6	12.4		
Normalised PBT	11.85	11.33	-4.4	12.32		
Normalised net income	9.59	9.29	-3.1	10.10		
Reported EPS (p)	20.2	18.0	-10.7	21.4		
Normalised EPS (p)	26.2	25.3	-3.7	27.5		
Net debt/(cash)	2.18	4.43	103.8	(2.25)		

Source: Edison Investment Research

Exhibit 5: Financial summary

£'000s	2012	2013	2014	2015	2016	2017e	2018e
Year end 30 June	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue	67,961	63,513	71,950	83,427	89,175	97,200	100,990
Cost of Sales	(28,491)	(30,375)	(32,990)	(40,446)	(40,636)	(44,830)	(46,744)
Gross Profit	39,470	33,138	38,960	42,981	48,539	52,370	54,246
EBITDA	12,942	7,261	9,861	10,975	12,843	15,930	17,166
Operating Profit (before am of acq. intang. and except.)	11,405	5,164	7,328	8,169	9,529	11,730	12,566
Amortisation of acquired intangibles	(3,586)	(3,182)	(2,989)	(2,800)	(2,734)	(2,900)	(2,900)
Share-based payments	(72)	(70)	(27)	(18)	(28)	(30)	(30)
Other	(395)	(727)	(1,722)	(546)	(1,538)	(500)	0
Operating Profit	7,352	1,185	2,590	4,805	5,229	8,300	9,636
Net Interest	(1,309)	(723)	(705)	(926)	(701)	(400)	(250)
Profit Before Tax (norm)	10,096	4,441	6,623	7,243	8,828	11,330	12,316
Profit Before Tax (FRS 3)	6,043	462	1,885	3,879	4,528	7,900	9,386
Tax	(319)	780	675	(436)	(425)	(1,416)	(1,687)
Profit After Tax (norm)	8,591	4,165	5,874	6,162	7,650	9,294	10,104
Profit After Tax (FRS 3)	5,724	1,242	2,560	3,443	4,103	6,484	7,699
Average Number of Shares Outstanding (m)	28.2	29.2	31.4	31.6	32.4	36.0	36.0
EPS - normalised (p)	30.4	14.3	18.7	19.5	23.6	25.8	28.1
EPS - normalised fully diluted (p)	29.7	14.1	18.5	19.1	23.0	25.3	27.5
EPS - FRS 3 (p)	20.3	4.3	8.1	10.9	12.6	18.0	21.4
Dividend per share (p)	1.00	1.00	1.25	1.50	1.75	1.93	2.12
Gross Margin (%)	58.1	52.2	54.1	51.5	54.4	53.9	53.7
EBITDA Margin (%)	19.0	11.4	13.7	13.2	14.4	16.4	17.0
Operating Margin (before GW and except.) (%)	16.8	8.1	10.2	9.8	10.7	12.1	12.4
BALANCE SHEET							
Fixed Assets	68,325	69,398	67,067	67,497	78,072	77,242	74,792
Intangible Assets	21,255	21,040	20,040	20,806	26,369	25,739	23,439
Tangible Assets	2,722	2,927	2,439	2,316	2,389	2,189	2,039
Goodwill	43,540	44,610	43,952	43,541	48,793	48,793	48,793
Other	808	821	636	834	521	521	521
Current Assets	32,418	25,523	29,535	33,734	43,695	46,098	51,479
Stocks	0	0	0	0	0	0	0
Debtors	30,322	25,251	28,888	31,839	40,923	41,809	43,440
Cash	2,096	272	647	1,895	2,772	4,288	8,039
Current Liabilities	(48,043)	(39,272)	(40,278)	(32,886)	(36,332)	(40,875)	(37,295)
Creditors	(8,797)	(5,842)	(7,218)	(7,640)	(8,324)	(9,061)	(9,409)
Other Creditors	(21,468)	(19,379)	(18,799)	(21,803)	(24,632)	(23,132)	(22,132)
Short term borrowings	(17,778)	(14,051)	(14,261)	(3,443)	(3,376)	(8,682)	(5,754)
Long Term Liabilities	(5,797)	(4,524)	(3,719)	(14,850)	(12,025)	(3,171)	(2,646)
Long term borrowings	0	(32)	(14)	(10,531)	(8,272)	(38)	(38)
Other long term liabilities	(5,797)	(4,492)	(3,705)	(4,319)	(3,753)	(3,133)	(2,608)
Net Assets	46,903	51,125	52,605	53,495	73,410	79,294	86,330
CASH FLOW							
Operating Cash Flow	7,284	8,022	5,352	9,600	5,498	13,781	14,884
Net Interest	(839)	(820)	(848)	(950)	(783)	(400)	(250)
Tax	(1,312)	(1,217)	290	(264)	(688)	(2,036)	(2,212)
Capex	(3,160)	(4,613)	(4,487)	(4,564)	(5,573)	(5,000)	(5,050)
Acquisitions/disposals	(7,132)	(1,917)	(129)	(1,998)	(7,386)	(1,270)	0
Financing	5,026	2,677	277	69	13,175	0	0
Dividends	(214)	(286)	(316)	(397)	(477)	(630)	(693)
Net Cash Flow	(347)	1,846	139	1,496	3,766	4,444	6,679
Opening net debt/(cash)	15,486	15,682	13,811	13,628	12,079	8,876	4,432
HP finance leases initiated	0	0	0	0	0	0	0
Other	151	25	44	53	(563)	0	0
Closing net debt/(cash)	15,682	13,811	13,628	12,079	8,876	4,432	(2,247)

Source: K3 Business Technology Group, Edison Investment Research

Frankfurt +49 (0)69 78 8076 960	London +44 (0)20 3077 5700	New York +1 646 653 7026	Sydney +61 (0)2 9258 1161	Wellington +64 (0)48 948 555
Schumannstrasse 34b	280 High Holborn	245 Park Avenue, 39th Floor	Level 25, Aurora Place	Level 15, 171 Featherston St
60325 Frankfurt	London, WC1V 7EE	10167, New York	88 Phillip St, Sydney	Wellington 6011
Germany	United Kingdom	US	NSW 2000, Australia	New Zealand