13 September 2016

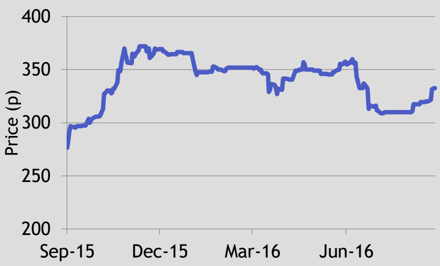
K3 BUSINESS TECHNOLOGY GROUP
SOFTWARE AND COMPUTER SERVICES

KBT.L

335p

Market Cap: £120.6m

SHARE PRICE (p)



12m high/low	372p / 276p

Source: LSE Data

KEY INFORMATION

Enterprise value	£129.5m
Index/market	FTSE AIM
Next news	AGM, Dec 16
Gearing	7%
Interest cover	13.6x

K3 BUSINESS TECHNOLOGY GROUP IS A RESEARCH CLIENT OF PROGRESSIVE

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Further progress, encouraging prospects

K3's FY 2016 results are broadly in line with management expectations and just a touch below our estimates at revenue and EBITDA level. Margins and profitability continue to benefit from transitioning the business into a software vendor with product suites that contain increasing levels of its own intellectual property. K3 had flagged a negative impact from a customer entering administration in its July trading update. That, and record sales activity at the year-end, impacted operating cash and left net debt at the previously announced £8.9 million at the end of June 2016. K3 has announced that CEO, David Bolton, will become Executive Chairman with a successor appointed in due course. We note record new orders, good momentum in the business and the benefits of cost reduction initiatives offset by further investment and slower revenue and profit recognition. We make reductions to our adjusted FY 2017 estimates and introduce FY 2018 estimates.

- The outlook statement notes encouraging prospects for FY 2017 with a strong pipeline building with channel partners as well as within its direct business. Initiatives to improve margins and costs support the prospect of increased profits and improved cash flows. K3 flags that changes in licence structures in the Microsoft market have accelerated customer activity, which is likely to normalise during FY2017.
- K3's cloud hosting and managed services activities grew strongly although a 'significant' customer, My Local, entered administration at the end of K3's financial year and the full year results reflect a write-off of £0.83 million.
- Two acquisitions have added new product sets in the current calendar year. The acquisition of DdD Retail in April brought a 'state-of-the-art' retail solution, "Retail in a Box", and Merac, acquired in July, is a leader in the visitor attractions retail sub-sector. Both deals were in line with Group strategy of seeking acquisitions which accelerate growth and also increase sales of K3-owned intellectual property.
- July's trading update provided a net debt number of £8.9m which, at the time, we noted was higher than our £6.1m estimate. Our estimates include further reductions in net debt.
- The group has continued to benefit from the switch towards recurring income (which has grown y/y) and a good number of contract wins and renewals. We are refining our FY 2017 estimates and introduce FY 2018 estimates.

FYE JUNE (£M)	FY14	FY15	FY16	FY17E	FY18E
Revenue	72.0	83.4	89.2	96.2	99.3
Adjusted EBITDA	**9.8**	**11.0**	**12.8**	**14.9**	**16.6**
Adjusted PBT	6.6	7.2	8.8	10.9	12.6
Adjusted EPS (p)	**18.4**	**19.2**	**22.9**	**25.0**	**28.7**
EV/Sales	1.8x	1.6x	1.5x	1.3x	1.3x
EV/ Adj. EBITDA	13.2x	11.8x	10.1x	8.7x	7.8x
P/E	**18.2x**	**17.5x**	**14.6x**	**13.4x**	**11.7x**

Source: Company Information and Progressive Equity Research estimates

FY 2016 results highlights

K3's full year results are broadly in line with management expectations and the trading update which the Group issued in July, detailing the write-off associated with the insolvency of one of its clients. Revenue and EBITDA are a touch below our estimates although we had not quantified the write-off in our numbers.

K3 had previously announced some important orders for its ax I is fashion retail product which included signing three major contracts through GSIs and new channel partners. The new business pipeline stood at a record level of £76.1 million at the end of FY 2016, up by 23% on a like-for-like basis from £62.0 million at the end of FY 2015. Within that, the channel partner pipeline was £4.61 million (FY 2015: £3.69 million).

The transition of the business to selling a greater proportion of products which contain increasing levels of its own intellectual property saw margins improve again. Approximately 25% of total software and maintenance licence revenues were generated by K3's own IP during the year. Overall, K3's reported numbers continue to be consistent with its focus on its own IP software products, channel sales and hosting.

Subsequent to the year end, K3 signed a deal to implement and supply New Microsoft Dynamics AX for Rank Group's Mecca Bingo and Grosvenor Casino businesses to replace two general ledger systems. It also, again, achieved the prestigious Inner Circle for Microsoft Dynamics in 2016. Membership is based on sales achievements that rank K3 in the top 1% of Microsoft Dynamics partners in terms of sales performance. K3 continues its partnership with Microsoft to provide its solutions on Azure and its own platforms which are specialised for the demands of ERP hosting.

Board changes

Today's announcement states that David Bolton, Chief Executive, will be relinquishing his role to take up the position of Executive Chairman while the current Chairman, Lars-Olof Norell, will become a Non-Executive Director. The process of appointing Mr Bolton's successor is 'well-advanced' with a further announcement expected 'in due course'.

Revenues

For FY 2016, total revenues rose by 7% to £89.2 million (FY 2015: £83.4 million) as H2 revenues grew by 12%. Within revenues:

- Recurring revenues represented 47% of the total income at £41.6 million (FY 2015: £39.9 million)
- Services revenue was up 4% to £25.7 million (FY 2015: £24.9 million)
- Software licence sales were £16.2 million (FY 2015: £13.8 million) an impressive performance given the ongoing shift towards consumption-based licencing which involves longer-term revenue recognition.
- K3's own IP product software licence revenue of £10.8 million represented 25% of the software and maintenance (enhancement licence) revenue in the period. Total revenues derived from its own IP amounted to £21.3 million (c. 24% of total Group sales).
- Divisionally, Retail revenues were £44.9 million (FY 2015: £39.7 million) while Manufacturing & Distribution revenues were up by 1% to £44.3 million.

Costs and margin

Overhead costs increased to £39.0 million (FY 2015: £34.8 million) which included a full year of Starcom overheads and two months of DdD overheads (FY 2015: nil). However, the gross margin rose to 54.4% (FY 2015: 51.5%) showing the benefits of the initiatives which the Group had previously put in place to reduce costs and reflecting higher software licences sales and the increase of K3's own IP in the sales mix. The gross margin on K3's own IP product software licence revenue was 66.2% versus 65.5% in FY 2015.

Profits

Adjusted profit from operations increased by 17% to £9.5 million (FY 2015: £8.2 million). Growth in H2 was 9%. K3 incurred exceptional costs of £1.05 million (FY 2015: £0.41m) relating to organisational and management changes mainly in the Retail operations (of which £0.85 million was reported in H1), and £0.49m of acquisition-related costs.

Reported profit before tax increased by 17% to £4.5 million (FY 2015: £3.9 million) while adjusted profit before tax increased by 22% to £8.8 million with adjusted earnings per share up 20% to 22.9p (FY 2015: 19.2p).

Tax charge

There was a net tax charge for the year of £0.43 million (FY 2015: £0.44 million) after the benefit of a £0.42 million deferred tax credit (2015: £0.26 million).

Net debt

Net debt decreased to £8.88 million from £12.08 million at the end of FY 2015. This reflects, inter alia, cash flow from operations which was £5.50 million (FY 2015: £9.60 million) after a very high level of activity at the close of the year, the acquisition of DdD in for £7.66m, the My Local write-off, weakening sterling and the placing which raised a net £13.04 million. The announcement notes that management expects operational cash to improve in FY 2017 with the unwinding of working capital and increase in development amortisation.

Divisions

Divisional Revenue (£m), Gross profit (£m) and Gross margins (%)

Retail	Revenue				Gross profit				Gross margin (%)			
	H1 2015	H2 2015	H1 2016	H2 2016	H1 2015	H2 2015	H1 2016	H2 2016	H1 2015	H2 2015	H1 2016	H2 2016
Software licences	4.1	3.1	4.5	5.8	2.9	2.3	3.1	4.4	70.3%	74.2%	69.6%	76.0%
Services	7.6	7.5	7.7	6.8	1.6	2.1	2.3	1.6	20.6%	27.5%	30.5%	23.1%
Recurring	6.8	8.0	6.2	10.5	3.8	5.7	4.4	6.6	56.6%	71.8%	70.8%	62.3%
Hardware and other	1.1	1.6	1.3	2.0	0.3	0.3	0.4	0.5	24.6%	21.3%	29.9%	25.8%
Total	**19.6**	**20.1**	**19.7**	**25.2**	**8.6**	**10.4**	**10.3**	**13.1**	**43.6%**	**51.7%**	**52.0%**	**52.0%**

Manufacturing and Distribution	Revenue				Gross profit				Gross margin (%)			
	H1 2015	H2 2015	H1 2016	H2 2016	H1 2015	H2 2015	H1 2016	H2 2016	H1 2015	H2 2015	H1 2016	H2 2016
Software licences	3.5	3.2	2.4	3.5	1.9	1.8	1.4	2.0	54.0%	56.0%	59.0%	58.0%
Services	4.3	5.4	5.5	5.7	1.6	2.6	2.2	2.0	37.0%	47.8%	40.2%	34.8%
Recurring	13.1	12.0	13.5	11.4	8.8	6.9	9.4	7.7	67.7%	57.5%	69.7%	67.4%
Hardware and other	1.1	1.0	1.2	1.1	0.2	0.2	0.2	0.2	18.4%	18.6%	19.0%	21.6%
Total	**22.0**	**21.7**	**22.6**	**21.7**	**12.6**	**11.5**	**13.3**	**11.9**	**56.9%**	**53.0%**	**58.8%**	**55.0%**

Source: Company information

Retail – highlights from FY 2016

- Sales up by 13% to £44.92 million
- Strong software licences sales - up 45% to £10.34 million with K3 product licence sales up by 33% to £7.34 million
- Recurring revenues increased by 13% to £16.74 million (37% of total retail sales)
- Impact of Microsoft's planned licensing structure changes are expected to become more evident over the coming year as customers have likely brought forward spending to beat changes to licence structures; this may result in a reduction in activity over the coming quarters.
- New orders almost doubled to £20.99 million (FY 2015: £11.3 million) with major contracts for both Microsoft Dynamics AX and Microsoft Dynamics NAV.
- Acquired DdD in April 2016 with its cloud-based "Retail in a Box" product. (Merac acquired after the year-end).
- Initiatives to reduce the cost base in K3's Dutch fashion and retail business
- Awarded "Inner Circle" status again and nominated as "Partner of the Year" in both product and implementation categories.
- New deal pipeline of £44.9 million (2015: £32.1 million).

Manufacturing and Distribution – highlights from FY 2016

- A 'challenging year', affected by a significant underperformance by Sage.
- Continuing momentum in hosting & managed services operations.
- Recurring income (56.2% of the total segment sales) was relatively unchanged year-on-year. SYSPRO maintenance and support renewals still account for the major part of recurring income with SYSPRO renewal rates static at 98%.
- Improvement in gross margin on recurring income, rising from 62.8% to 68.6% reflecting the increase in higher margin hosting support income.
- Software licence income decreased by 12% to £5.89 million – mainly in lower margin Sage product and CRM software.
- Services revenue at £11.22m was up 15%, reflecting higher levels of activity in the Microsoft Dynamics business, CRM and hosting implementation work.
- Encouraging new orders - up by 43% to £14.3 million (FY 2015: £10.0 million). The Microsoft Dynamics NAV and AX business had a very strong second half.
- SYSPRO business performed robustly but the level of new business orders in the second half was disappointing and K3 has taken action to refresh the new business sales team.
- A disappointing performance from the Sage operation saw changes to the sales team at the end of the period.
- Cloud hosting & managed services businesses progressed well, benefiting from the addition of Starcom, acquired in April 2015.
- Despite the effect of My Local going into administration, K3 sees 'very good' underlying momentum with the business 'well placed for growth'.

Estimates

Following today's FY 2016 results announcement, we are making adjustments to our FY 2017 estimates and introduce numbers for FY 2018 for the first time. As we have previously noted, revenues continue to reflect the shift towards subscription-based contracts and the changes in licence structures in the Microsoft market may act as a modest headwind during the early part of FY2017.

The balance between further investment and previous cost reduction initiatives also influences our numbers. Although the tax charge has again benefited from deferred tax credits again, our EPS estimates are struck using a higher effective tax rate than that reported in FY 2016. We also make small alterations to our forecast numbers of shares in issue.

In combination, these adjustments to our assumptions lead to the estimate changes in the table below. Our full financial forecast tables are shown overleaf.

Actual FY 2016 and estimate changes for FY 2017

	FY16			FY17E		
£m unless stated	**Est**	**Act**	**Diff.**	**Old**	**New**	**Change (%)**
Revenue	89.6	89.2	-0.5%	96.9	96.2	-0.7%
Adj EBITDA	13.0	12.8	-1.4%	16.2	14.9	-7.8%
Reported PBT	5.5	4.5	-17.1%	8.8	6.8	-23.4%
Fully adj PBT	9.4	8.8	-6.4%	12.0	10.9	-8.6%
Reported EPS (p)	13.4	12.3	-8.1%	19.5	14.8	-23.9%
Fully adj EPS (p)	23.6	22.9	-2.8%	27.7	25.0	-9.8%

Source: Progressive Equity Research estimates

SUMMARY FINANCIALS

Profit & Loss	FY-13A	FY-14A	FY-15A	FY-16A	FY-17E	FY-18E
Revenue	**63.5**	**72.0**	**83.4**	**89.2**	**96.2**	**99.3**
Adj EBITDA	7.2	9.8	11.0	12.8	14.9	16.6
Adj EBITA	**5.1**	**7.3**	**8.2**	**9.5**	**11.5**	**12.7**
Reported PBT	0.5	1.9	3.9	4.5	6.8	8.6
PBT before exceptionals and AAG	4.4	6.6	7.2	8.8	10.9	12.6
Fully adj PBT	**4.4**	**6.6**	**7.2**	**8.8**	**10.9**	**12.6**
NOPAT	4.4	6.2	7.0	7.8	9.6	10.6
Reported EPS (p)	4.2	8.1	10.7	12.3	14.8	18.8
EPS before exceptionals and AAG (p)	13.9	18.4	19.2	22.9	25.1	28.9
Fully adj EPS (p)	**13.9**	**18.4**	**19.2**	**22.9**	**25.0**	**28.7**
Dividend per share (p)	1.0	1.3	1.5	1.8	1.9	2.0

Cash flow & Balance sheet	FY-13A	FY-14A	FY-15A	FY-16A	FY-17E	FY-18E
Operating cash flow	8.0	5.4	9.6	5.5	12.9	12.8
Free Cash flow £m	1.1	(0.0)	8.4	(2.0)	5.9	5.9
FCF per share p	3.7	(0.0)	26.1	(6.0)	16.2	16.2
Acquisitions	(1.9)	(0.1)	(6.6)	(7.4)	(0.9)	0.0
Disposals	0.0	0.0	0.0	0.0	0.0	0.0
Shares issued	2.7	0.3	0.1	13.2	0.0	0.0
Net cash flow	**2.0**	**0.1**	**1.6**	**3.8**	**5.0**	**5.9**
Net (Debt)/Cash	**(13.8)**	**(13.6)**	**(12.1)**	**(8.9)**	**(3.9)**	**2.1**

NAV and returns	FY-13A	FY-14A	FY-15A	FY-16A	FY-17E	FY-18E
Net asset value	51.1	52.6	53.5	73.4	78.2	84.5
NAV/share (p)	**162.6**	**165.8**	**169.1**	**203.9**	**217.4**	**234.8**
Net Tangible Asset Value	(14.5)	(11.4)	(10.9)	(1.8)	5.3	14.1
NTAV/share (p)	**(46.2)**	**(35.9)**	**(34.3)**	**(4.9)**	**14.6**	**39.1**
Average equity	49.0	51.9	53.1	63.5	75.8	81.4
Post-tax ROE (%)	**2.5%**	**4.9%**	**6.5%**	**6.5%**	**7.2%**	**8.5%**

Metrics	FY-13A	FY-14A	FY-15A	FY-16A	FY-17E	FY-18E
Revenue growth	*-6.5%*	*13.3%*	*16.0%*	*6.9%*	*7.9%*	*3.2%*
Adj EBITDA growth	*-44.1%*	*36.8%*	*11.4%*	*17.0%*	*16.4%*	*11.2%*
Adj EBIT growth	*-55.1%*	*43.3%*	*11.6%*	*16.6%*	*21.5%*	*10.1%*
Adj PBT growth	*-56.4%*	*50.9%*	*9.5%*	*21.8%*	*24.3%*	*15.1%*
Adj EPS growth	*-52.9%*	*32.8%*	*4.1%*	*19.7%*	*8.9%*	*15.1%*
Dividend growth	*0.0%*	*25.0%*	*20.0%*	*16.7%*	*5.7%*	*5.4%*
Adj EBIT margins	*8.0%*	*10.1%*	*9.8%*	*10.7%*	*12.0%*	*12.8%*

Valuation	FY-13A	FY-14A	FY-15A	FY-16A	FY-17E	FY-18E
EV/Sales	2.0	1.8	1.6	1.5	1.3	1.3
EV/EBITDA	18.0	13.2	11.8	10.1	8.7	7.8
EV/NOPAT	29.5	21.0	18.6	16.5	13.4	12.2
PER	24.2	18.2	17.5	14.6	13.4	11.7
Dividend yield	0.3%	0.4%	0.4%	0.5%	0.6%	0.6%
FCF yield	1.1%	0.0%	7.8%	-1.8%	4.8%	4.8%

Source: Company information, Progressive Equity Research estimates

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