

## K3 BUSINESS TECHNOLOGY GROUP

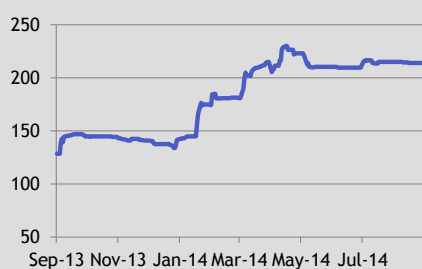
### SOFTWARE & COMPUTER SERVICES

**KBT.L**

214p

Market Cap: £67.9m

#### SHARE PRICE (p)



12m high/low

230.0p/128.6p

**Source: LSE Data**

#### KEY INFORMATION

Enterprise value	£81.4m
Index/market	FTSE AIM
Next news	AGM November 2014
Gearing	20%
Interest cover	14.4x

**K3 BUSINESS TECHNOLOGY IS A  
 RESEARCH CLIENT OF PROGRESSIVE**

#### ANALYSTS

Gareth Evans  
 +44 (0)20 7349 5156  
 gevens@progressive-research.com

Ian Poulter  
 +44 (0)20 7349 5156  
 ipoulter@progressive-research.com

## Full year results reflect ax|is product growth

### Encouragement across the Group

K3's July trading update flagged an in-line performance for the year to June 2014. That is reflected in the FY14 results within which revenues and adjusted EBITDA were a touch better than we expected. The dividend increase of 25% to 1.25p is ahead of our estimate. The results show positive numbers for adjusted profits in both the Microsoft UK and Managed Services Divisions after losses last year. Slightly lower profits from the other two divisions reflect slow markets, investment and a small disposal - but both finished the year in encouraging fashion. Looking ahead, management expects to make further investment in growth opportunities and produce good results from its Microsoft AX Dynamics proposition. On the back of this strength, we upgrade our FY15 estimates (c.5% at the Adjusted PBT level) and introduce our FY16 numbers.

- The building of the relationship with Microsoft is showing encouraging results. The ax|is product drove the Division's improved performance and represented half of the value of major contract wins during FY14.
- The Group again notes the opportunity to move the ax|is product into new territories with Microsoft supportive of this move. Using K3's global partner channel, this should bring margin benefits.
- Managed Services continued its turnaround with run rate recurring income at the year-end showing a 16% increase to £5.30 million.
- The Sage business 'enjoyed an extremely good second half' with successes for the X3 product. We would expect that to offer a tailwind into FY15. The SYSPRO business performed well and continues to produce useful levels of recurring income. It is likely to receive some more investment to refresh its growth potential.
- The International Division notes good early interest in the enhanced retail solution. The results announcement also highlights the commencement of a major work stream for IKEA franchisee at the end of the period which bodes well for FY15 revenues.
- Although there will be further investment spend, K3 should also be able to manage costs through outsourcing agreements with an associated benefit to margins.

FYE JUNE	2012	2013	2014	2015E	2016E
Revenue	68.0	63.5	72.0	79.6	87.7
Adjusted EBITDA	12.9	7.3	9.9	11.5	13.2
Adjusted PBT	10.0	4.4	6.6	8.0	9.7
Adjusted EPS	24.4	13.9	18.4	20.2	24.4
EV/Sales	1.2x	1.3x	1.1x	1.0x	0.9x
EV/ Adj. EBITDA	6.3x	11.2x	8.3x	7.1x	6.2x
P/E	8.8x	15.4x	11.6x	10.6x	8.8x
Dividend yield (%)	0.5%	0.5%	0.6%	0.7%	0.8%

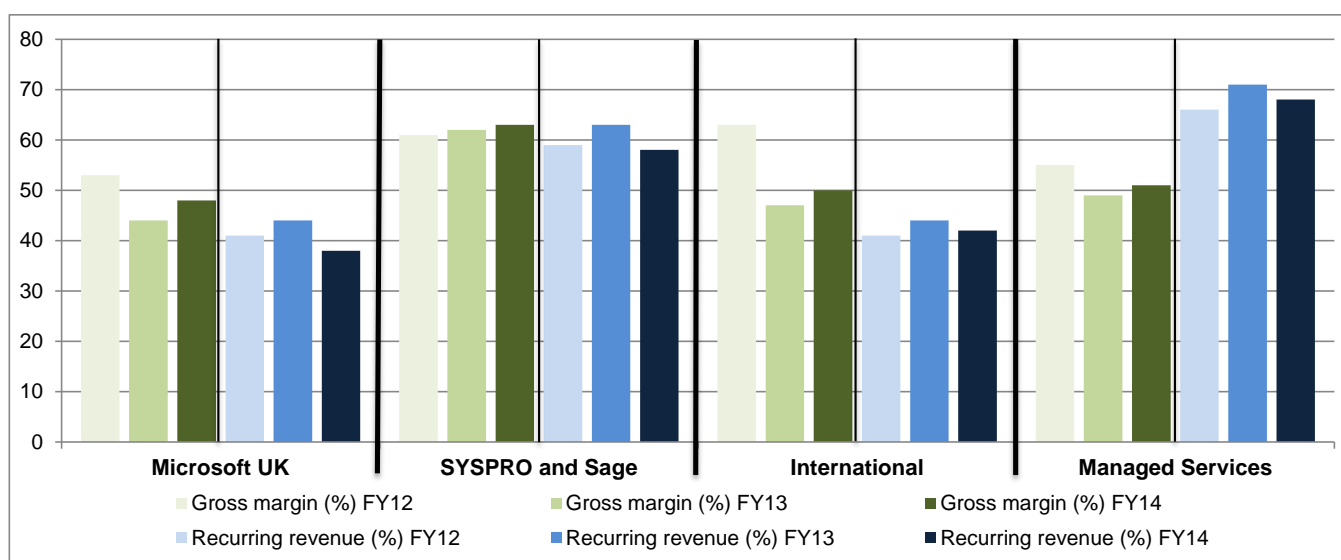
**Source: Company Information and Progressive Equity Research estimates**

## The FY14 results

### Summary

K3's FY14 results contain further improvement in performance in H2 and include a greater level of major orders (£25.3 million, up 114%) over the year compared to FY13. Within that, axjis solutions accounted for approximately £12.63 million. Notably, the performances of both the Microsoft UK and Managed Services Divisions have produced positive adjusted profits compared to losses in FY13. The overall numbers continue to reflect the amount of investment which has been made in the business. International and Sage & SYSPRO Divisions reported slightly lower profits than in FY13. The former had to contend with some impact from slower markets and a small disposal in 2013 - as well as the increased investment spend - but reported good momentum at the period-end. The Sage & SYSPRO Division ended FY14 in encouraging shape. The SYSPRO business produced good levels of new business wins and the Sage business benefitted from previous investment resulting in a strong Q4 performance - with the X3 ERP solution a particular highlight. Margins increased across the Divisions. Recurring revenue increased by 2.5% to £35.42 million during FY14. The 25% increase in the dividend is welcome as the Board acknowledges the improving prospects for the Group.

### Divisional gross margins and levels of recurring revenues (%)



Source: K3 information

### Net debt

Net debt at 30 June 2014 was little changed at £13.63m (and £1.7 million higher than we estimated) after some £4.0 million of investment in product development during the year - the fruits of which started to show through in the current year profit improvement. Over the coming two financial years, we would expect net debt to reduce as the level of cash exceptional items drops away and the working capital requirement steadies.

## Exceptional items

K3 incurred exceptional costs of £1.72 million in FY14 (FY13: £0.73m) – a little higher than we anticipated – reflecting the restructuring of the Microsoft UK Division and Managed Services Division and some restructuring of prior acquisitions as well as senior management changes. The Group does not expect major exceptional costs in the coming year.

## Other main points at Group level

- Revenues of £71.95 million (FY13: £63.51 million), up by 13%.
- Recurring revenues of £35.42 million (FY13: £34.54 million), up 2.5%, representing 49% (FY13: 54%) of Group income.
- Adjusted profit from operations (before amortisation of acquired intangibles and exceptional reorganisation costs) of £7.30 million (FY13: £5.01 million) up by 46%.
- Adjusted profit before tax of £6.60 million (FY13: £4.37 million), up by 51%.
- Adjusted diluted earnings per share of 18.4p (FY13: 13.9p), up 33%.
- Operating cash flow of £5.33 million (FY13: £8.02 million).
- The results announcement notes that, in future, K3 will report by reference to its industry sectors (retail, manufacturing and distribution) and its global intellectual property.

## Estimates

Our estimates for adjusted PBT and EPS numbers in FY15 increase by 5% and 3% respectively. They reflect a 3% increase in revenue expectations, slightly higher cost assumptions and a change in the mix of profit contributions from the Divisions which includes a higher blended margin estimate. The latter point reflects where the bias of higher likely investment spend will fall during the year as the Group invests in the growth potential of SYSPRO and expansion of the International business – but it also encompasses the benefits of previous investment made by the Group. We are expecting a reduction in net debt over the next two financial years and, with the first-time introduction of our FY16 numbers, we are looking for net debt of around £5.5 million as at June 2016. We have also increased our dividend expectations following the 25% increase in FY14.

### Estimate changes

FY15E	Old	New	Change (%)
Revenue (£m)	77.5	79.6	2.7%
Adjusted EBITDA (£m)	10.5	11.5	9.7%
Adjusted PBT (£m)	7.6	8.0	4.8%
Fully adjusted PBT (£m)	7.7	8.0	4.2%
Fully adjusted EPS (p)	19.6	20.2	3.1%
Dividend (p)	1.2	1.5	25.0%

Source: *Progressive Equity Research estimates*

## FINANCIAL FORECASTS

Year ended Jun	FY-12	FY-13	FY-14	FY-15	FY-16
	£m	£m	£m	£m	£m
<b>Profit &amp; Loss</b>	<b>Act</b>	<b>Act</b>	<b>Act</b>	<b>Est</b>	<b>Est</b>
Revenue £m	68.0	63.5	72.0	79.6	87.7
Adj EBITDA £m	12.9	7.3	9.9	11.5	13.2
Adj EBIT £m	11.4	5.2	7.3	8.8	10.5
Reported PBT	6.0	0.5	1.9	4.8	6.6
PBT before exceptionals and AAG	10.0	4.4	6.6	8.0	9.7
Fully adj PBT	10.1	4.4	6.6	8.0	9.7
NOPAT £m	8.0	3.6	5.1	6.2	7.3
Reported EPS	19.8	4.2	8.1	12.1	16.5
EPS before exceptionals and AAG	24.3	10.4	20.8	20.1	24.3
Fully adj EPS	24.4	13.9	18.4	20.2	24.4
Dividend per share p	1.00	1.00	1.25	1.50	1.75
<b>Cash flow &amp; Balance sheet</b>					
Operating cash flow	7.3	8.0	6.3	10.2	11.9
Free Cash flow £m	3.6	3.9	2.3	4.9	6.6
FCF per share p	12.4	13.2	7.4	15.5	20.7
Capex	-3.2	-4.6	-4.5	-4.0	-4.0
Acquisitions	-7.1	-1.9	-0.1	0.0	0.0
Net cash flow	-5.4	-0.8	0.0	3.2	4.8
Shares issued	5.0	2.7	0.3	0.0	0.0
Net cash	-15.7	-13.8	-13.6	-10.3	-5.5

<b>Metrics</b>	<b>FY-12</b>	<b>FY-13</b>	<b>FY-14</b>	<b>FY-15</b>	<b>FY-16</b>
Revenue growth	28.7%	-6.5%	13.3%	10.7%	10.1%
Adj EBITDA growth	22.4%	-43.9%	35.8%	16.8%	14.5%
Adj EBIT growth	18.4%	-54.7%	41.9%	20.4%	18.9%
Adj PBT growth	15.7%	-56.0%	49.1%	21.1%	20.8%
Adj EPS growth	7.2%	-43.2%	32.8%	9.8%	20.8%
Dividend growth	33.3%	0.0%	25.0%	20.0%	16.7%
Adj EBIT margins	16.8%	8.1%	10.2%	11.1%	12.0%
Operating cash conversion	56%	110%	63%	89%	90%
Capex/Depreciation	206%	219%	176%	148%	148%

<b>Valuation</b>	<b>FY-12</b>	<b>FY-13</b>	<b>FY-14</b>	<b>FY-15</b>	<b>FY-16</b>
EV/sales	1.2	1.3	1.1	1.0	0.9
EV/EBITDA	6.3	11.2	8.3	7.1	6.2
EV/NOPAT	10.2	22.5	15.9	13.2	11.1
PER	8.8	15.4	11.6	10.6	8.8
Dividend yield	0.5%	0.5%	0.6%	0.7%	0.8%
FCF yield	5.8%	6.2%	3.5%	7.2%	9.7%

Source: K3 information, Progressive Equity Research estimates

## Disclaimers and Disclosures

Copyright 2014 Progressive Equity Research Limited (“PERL”). All rights reserved. PERL provides professional equity research services, and the companies researched pay a fee in order for this research to be made available. This report has been commissioned by the subject company and prepared and issued by PERL for publication in the United Kingdom only. All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable; however, PERL does not guarantee the accuracy or completeness of this report. Opinions contained in this report represent those of the research department of PERL at the time of publication, and any estimates are those of PERL and not of the companies concerned unless specifically sourced otherwise. PERL is not regulated by the Financial Conduct Authority (FCA).

This document is provided for information purposes only, and is not a solicitation or inducement to buy, sell, subscribe, or underwrite securities or units. Investors should seek advice from an Independent Financial Adviser or regulated stockbroker before making any investment decisions. PERL does not make investment recommendations. Any valuation given in a research note is the theoretical result of a study of a range of possible outcomes, and not a forecast of a likely share price. PERL does not undertake to provide updates to any opinions or views expressed in this document.

This document has not been approved for the purposes of Section 21(2) of the Financial Services & Markets Act 2000 of the United Kingdom. This document is a marketing communication under FCA Rules. It has not been prepared in accordance with the legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research.

PERL does not hold any positions in the securities mentioned in this report. However, PERL’s directors, officers, employees and contractors may have a position in any or related securities mentioned in this report. PERL or its affiliates may perform services or solicit business from any of the companies mentioned in this report.

The value of securities mentioned in this report can fall as well as rise and may be subject to large and sudden swings. In addition, the level of marketability of the shares mentioned in this report may result in significant trading spreads and sometimes may lead to difficulties in opening and/or closing positions. It may be difficult to obtain accurate information about the value of securities mentioned in this report. Past performance is not necessarily a guide to future performance.