

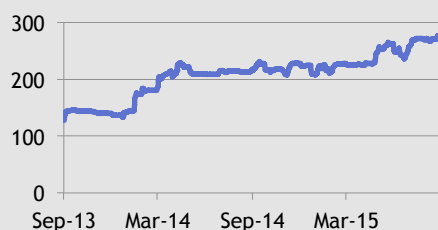
## K3 BUSINESS TECHNOLOGY GROUP SOFTWARE AND COMPUTER SERVICES

### KBT.L

278p

Market Cap: £88.0m

#### SHARE PRICE (p)



12m high/low

278p/208p

Source: LSE Data

#### KEY INFORMATION

Enterprise value	£101.6m
Index/market	FTSE AIM
Next news	H1 FY16, Mar 16
Gearing	15%
Interest cover	11.7x

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

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### Further positive progress

K3 has reported FY15 results in line with the trading update of July, with revenue slightly ahead of our estimates, adjusted PBT slightly behind, but adjusted EPS almost exactly on our forecasts. The group is seeing a good combination of positive market backdrop and support from Microsoft. Also announced was a major contract with German group TriStyle, which provides evidence of many of these positives. We make modest (c6%) reductions to FY16E earnings estimates to reflect currency pressures, but hopefully the new forecasts will prove conservative given the momentum across much of the group.

- K3 has reported FY15 (to June) as largely heralded in the group's trading update of mid-July. Revenue was some £83.4m vs our £81.7m forecast, adjusted PBT was slightly shy at £7.2m (vs our £7.7m) and adjusted EPS almost exactly in-line at 19.4p (we had 19.5p). Net debt was, as described in July, just over £12m.
- The group has delivered a strong performance across the board, with licence sales up 7%, services up 25% and recurring revenues up 13% over the prior year. The Microsoft relationship and the Managed Services initiative are both beginning to bear fruit in a material way, with the global footprint of the former and the recurring revenue of the latter combining to dramatically enhance "quality of earnings".
- Sterling strength drives a modest reduction in our FY16E forecasts (we cut Adj PBT from £10.2m to £9.5m, with a concomitant drop in EPS), and we also model a £0.6m cash exceptional as costs are reduced. Our new estimates are shown below and overleaf.
- The group has also published a major contract announcement in relation to TriStyle Mode, a large German retailer. The deal is arguably a perfect example of the positive aspects we are highlighting, and we provide further comment overleaf.

Overall, FY15 has been a strong year for K3, with strong revenue and profit growth, and a significant broadening in the offering, the routes to market and the geographic reach. We hope that our new forecasts for FY16E (and newly-introduced estimated for FY17E) will prove cautious. The group has moved forward materially in recent years to focus on in-house intellectual property within its software. FY16 should, in our view, continue to demonstrate the benefits of this transition.

FYE JUNE (£M)	FY13	FY14	FY15	FY16E	FY17E
<b>Revenue</b>	63.5	72.0	83.4	91.1	97.1
<b>Adjusted EBITDA</b>	<b>7.3</b>	<b>9.9</b>	<b>10.9</b>	<b>13.1</b>	<b>15.9</b>
<b>Adjusted PBT</b>	4.4	6.6	7.2	9.5	11.4
<b>Adjusted EPS (p)</b>	<b>13.9</b>	<b>18.4</b>	<b>19.1</b>	<b>24.8</b>	<b>29.7</b>
<b>EV/Sales</b>	1.6x	1.4x	1.2x	1.1x	1.0x
<b>EV/ Adj. EBITDA</b>	14.1x	10.3x	9.4x	7.7x	6.4x
<b>P/E</b>	<b>20.0x</b>	<b>15.1x</b>	<b>14.5x</b>	<b>11.2x</b>	<b>9.4x</b>

Source: Company Information and Progressive Equity Research estimates

## Additional comment

### TriStyle Mode

The “major contract” win with TriStyle Mode is in our view interesting, despite the lack of financial detail, for a number of different reasons:

- The RNS describes the deal as a “major contract”, which in our view, given the scale of K3 and its previous announced contract sizes, suggests multiple hundreds of thousands of pounds in terms of licence revenue
- As a material win through the group’s channel partner network, the contract demonstrates that K3’s intellectual property (within the software) can deliver enterprise-grade retail platforms, and that these platforms can be sold (and then integrated) by third parties such as traditional systems integration houses
- The specific systems integrator is not named; we would suggest that the short-list for partners would be: PwC, IBM, Avanade and Hitachi – any of these would have the global presence described in the RNS and also potentially the local relationship to drive a sale in Germany
- Finally, we note that TriStyle Mode itself has recently undergone a change of ownership (into private equity hands); we would be surprised if the new owners had not been very careful to ensure that the IT plans were robust and reliable, adding an extra degree of strength in terms of TriStyle as a reference site

### Order wins

The level of order wins is shown at c£21m (down from £25m in FY2013/14); this looks at first sight like a somewhat disappointing slowdown. In reality, and as described at the time, the FY13/14 order intake was an extraordinarily high figure, more than double the year before (FY12/13 was c.£11.6m, and FY11/12 some £13.0m). In this light, an order intake of £21m in major deals still represents an extremely strong performance.

### Managed Services

The group, after a number of years, is starting to see its Managed Services business grow towards maturity. The customer base of the Cloud hosting and managed services combination is now some 450 strong, with annualised recurring revenues of £8.0m.

We have long been supporters of the group’s push towards Managed Services, and the potential is now being gradually realised, partly through organic delivery, and partly through acquisition of adjacent and relevant service lines (note the Willow Starcom deal late in the year). We continue to believe that K3, through its software intellectual property, should be able to drive super-normal returns from a managed services business, and that the recurring revenues allied with such a business model will be highly valued by investors.

### Continued transition

Finally, it is worth highlighting the ongoing very material transition in the group. Not many years ago, K3’s strategy was to acquire software resellers and drive down costs, hoping that another party would acquire the resultant customer list and revenue stream in order to realise value. The last three or so years have seen K3 seize this opportunity itself; developing and now effectively selling the software that customers value, and allowing both K3 and increasingly its channel partners to build profitable revenue streams assisting and supporting the end customers’ plans.

## FINANCIAL SUMMARY

Year ended June	FY-12	FY-13	FY-14	FY-15	FY-16	FY-17
	£m	£m	£m	£m	£m	£m
<b>Profit &amp; Loss</b>	<b>Act</b>	<b>Act</b>	<b>Act</b>	<b>Act</b>	<b>Est</b>	<b>Est</b>
<b>Revenue</b>	<b>68.0</b>	<b>63.5</b>	<b>72.0</b>	<b>83.4</b>	<b>91.1</b>	<b>97.1</b>
Adj EBITDA	12.9	7.2	9.8	10.9	13.1	15.9
<b>Adj EBIT</b>	<b>11.3</b>	<b>5.1</b>	<b>7.3</b>	<b>8.2</b>	<b>10.4</b>	<b>12.1</b>
Reported PBT	6.0	0.5	1.9	3.7	5.8	8.3
PBT before exceptionals and AAG	10.0	4.4	6.6	7.2	9.5	11.4
<b>Fully adj PBT</b>	<b>10.0</b>	<b>4.4</b>	<b>6.6</b>	<b>7.2</b>	<b>9.5</b>	<b>11.4</b>
NOPAT £	9.3	4.4	6.2	7.0	8.8	10.1
Reported EPS (p)	19.8	4.2	8.1	10.1	14.4	20.5
EPS before exceptionals and AAG (p)	29.5	13.9	18.4	19.1	24.8	29.7
<b>Fully adj EPS (p)</b>	<b>29.5</b>	<b>13.9</b>	<b>18.4</b>	<b>19.1</b>	<b>24.8</b>	<b>29.7</b>
Dividend per share (p)	1.0	1.0	1.3	1.5	1.8	1.9
<b>Cash flow &amp; Balance sheet</b>						
Operating cash flow	7.3	8.0	5.4	9.6	9.1	14.2
Free Cash flow £m	1.8	1.1	0.0	8.4	2.5	5.8
FCF per share p	6.1	3.7	0.0	26.1	7.6	18.0
Capex	-3.2	-4.6	-4.5	-3.8	-4.0	-5.5
Acquisitions	-7.1	-1.9	-0.1	-2.8	0.0	0.0
Net cash flow	-0.5	2.0	0.1	5.5	2.5	5.8
Shares issued	5.0	2.7	0.3	0.0	0.0	0.0
<b>Net (debt)/cash</b>	<b>-15.7</b>	<b>-13.8</b>	<b>-13.6</b>	<b>-12.0</b>	<b>-9.5</b>	<b>-3.7</b>
<b>Metrics</b>	<b>FY-12</b>	<b>FY-13</b>	<b>FY-14</b>	<b>FY-15</b>	<b>FY-16</b>	<b>FY-17</b>
Adj EBIT growth		-55.1%	43.3%	11.6%	28.2%	15.4%
Adj PBT growth		-56.4%	50.9%	9.5%	31.9%	19.5%
Adj EPS growth		-52.9%	32.8%	4.0%	29.7%	19.5%
Dividend growth		0.0%	25.0%	20.0%	16.7%	5.7%
Adj EBIT margins	16.7%	8.0%	10.1%	9.8%	11.5%	12.4%
<b>Valuation</b>	<b>FY-12</b>	<b>FY-13</b>	<b>FY-14</b>	<b>FY-15</b>	<b>FY-16</b>	<b>FY-17</b>
EV/Sales	1.5	1.6	1.4	1.2	1.1	1.0
EV/EBITDA	7.9	14.1	10.3	9.4	7.7	6.4
EV/NOPAT	10.9	23.2	16.5	14.6	11.6	10.0
PER	9.4	20.0	15.1	14.5	11.2	9.4
Dividend yield	0.4%	0.4%	0.4%	0.5%	0.6%	0.7%
FCF yield	2.2%	1.3%	0.0%	9.4%	2.7%	6.5%

Source: Progressive Equity Research Ltd estimates, company information

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