

K3 BUSINESS TECHNOLOGY GROUP

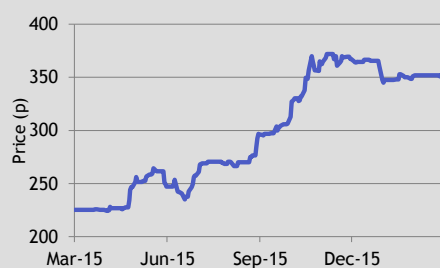
SOFTWARE AND COMPUTER SERVICES

KBT.L

352.5p

Market Cap: £111.4m

SHARE PRICE (p)



12m high/low

372p / 224p

Source: LSE Data

KEY INFORMATION

Enterprise value	£121.86m
Index/market	FTSE AIM
Next news	FY16, Sep 16
Gearing	12%
Interest cover	12.6x

K3 BUSINESS TECHNOLOGY GROUP IS A RESEARCH CLIENT OF PROGRESSIVE

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First half results in line as progress continues

Subscription contracts are increasingly influential

K3's first half results for its current financial year to the end of June 2016 are in line with management expectations and reflect a strong performance from retail activities and cloud hosting. The Group has continued to progress its strategy of transitioning the business into a software vendor with product suites that contain increasing levels of its intellectual property and the outlook remains positive. Group revenue growth reflected the anticipated combined effects of a shift towards cloud-based consumption and a weaker Euro than in the comparator period. Profitability showed the expected improvement with useful sales through channel partners (a key focus for expansion) complementing direct sales and cost reductions. As flagged, net debt was at a reduced £10.45m. We adjust estimates to reflect, *inter alia*, the evolving revenue and investment profiles.

- Revenues increased by 1%, or 4% at constant currency rates (CCR), in the first half to £42.3 million. There was good growth in K3's focus areas of its own IP, channel sales and hosting. Adjusted PBT grew by 33% (36% at CCR) while Adjusted EPS grew by 43% as the Group saw benefits from cost reduction initiatives.
- The outlook statement points to 'healthy' pipelines in both its Retail and Manufacturing and Distribution activities and flags continued investment in product development.
- K3 had previously announced that it had secured its first orders through global systems integrators (GSIs) for the ax|is fashion solution in the first half.
- The Group has also noted growing demand for its cloud hosting and expects increasing adoption of subscription models as the industry moves towards consumption-based licensing. Revenues will reflect that shift as subscription contracts will provide income which is recognised over longer time periods (and less up-front) but with a potentially greater lifetime value of such contracts.
- We reduce revenue estimates by around 3% in FY 2016E and 8% in FY 2017E to reflect the revenue profile noted above and adjust assumptions for investment spend and depreciation. Adjusted earnings reduce by around 6% and 13% for FY 2016E and FY 2017E respectively.

FYE JUNE (£M)	FY13	FY14	FY15	FY16E	FY17E
Revenue	63.5	72.0	83.4	88.6	89.8
Adjusted EBITDA	7.2	9.8	10.9	12.8	14.5
Adjusted PBT	4.4	6.6	7.2	9.1	9.9
Adjusted EPS (p)	13.9	18.4	19.1	23.3	25.8
EV/Sales	1.9x	1.7x	1.5x	1.4x	1.4x
EV/ Adj. EBITDA	16.9x	12.4x	11.2x	9.5x	8.4x
P/E	25.4x	19.1x	18.4x	15.1x	13.7x

Source: Company Information and Progressive Equity Research estimates

H1 2016 results highlights

K3's interim results are in line with management expectations and the trading update which the Group issued earlier this year and include strong performances from retail activities and cloud hosting. While revenues are a little below our run-rate expectations, so are costs, although the announcement notes that the group will continue to invest 'significantly' in developing its product offerings.

The half year numbers remain consistent with K3's focus on its own IP software products, channel sales and hosting. K3 has previously announced some important orders for its ax I is fashion retail product and during the first half it signed three major contracts through GSIs and new channel partners. It remains a member of the Microsoft Dynamics 'Inner Circle' and 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. K3 provides a range of products and services suitable for all types of business, catering for basic to high end requirements.

Revenues

For H1 2016, total revenues rose by 1% (+4% at CCR) to £42.29 million (H1 2015: £41.67 million) affected by consumption licencing and a weaker average rate for the Euro versus sterling compared to the comparator period (the second half of calendar 2014). Within revenues:

- Recurring revenues represented 47% of the total income at £19.72 million (H1 2015: £19.84 million)
- Services revenue was up 11% to £13.19m (H1 2015: £11.93m)
- Software licence sales were £6.88 million (H1 2015: £7.63 million) reflecting the expected shift towards consumption-based licencing.
- K3's own IP product software licence revenue of £4.89 million represented 25% (H1 2015: 23%) of all product software licence revenue sold in the period. Total revenues derived from its own IP amounted to £9.56 million (c. 23% of total sales).
- Divisionally, Retail revenues were £19.72 million (H1 2015: £19.63 million) while Manufacturing & Distribution revenues were up by 2.4% to £22.57 million.

Costs and margin

Overhead costs increased to £18.4 million (H1 2015: £17.0 million) mainly due to additional personnel costs. However, the gross margin rose to 56% (H1 2015: 51%) showing the benefits of the initiatives which the Group had previously put in place to reduce costs through in-house training and near-shore resourcing. It also reflected the higher margin on the hosting and managed services businesses. The gross margin on K3's own IP product software licence revenue was 65.5% versus 63.9% in H1 2015.

Profits

Adjusted profit from operations increased by 24% to £5.11 million (H1 2015: £4.11m). The announcement notes that management sees the impact of the reorganisations and management changes (announced in September 2015) in this improvement noting, in particular, a step change in the performance of the retail operation. The associated £0.85 million cost of achieving those changes is reported as an exceptional item in the interim results. Reported profit before tax increased by 27% to £2.28 million (H1 2015: £1.79m) while adjusted profit before tax increased by 33% to £4.72 million with adjusted earnings per share up 43% to 12.0p (H1 2015: 8.4p).

Divisions

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

Retail	Revenue		Gross profit		Gross margin (%)	
	H1 2015	H1 2016	H1 2015	H1 2016	H1 2015	H1 2016
Software licences	4.08	4.50	2.87	3.13	70.3%	69.6%
Services	7.63	7.68	1.57	2.34	20.6%	30.5%
Recurring	6.78	6.20	3.84	4.39	56.6%	70.8%
Hardware and other	1.14	1.34	0.28	0.40	24.6%	29.9%
Total	19.63	19.72	8.56	10.26	43.6%	52.0%

Manufacturing and Distribution	Revenue		Gross profit		Gross margin (%)	
	H1 2015	H1 2016	H1 2015	H1 2016	H1 2015	H1 2016
Software licences	3.54	2.39	1.91	1.41	54.0%	59.0%
Services	4.30	5.50	1.59	2.21	37.0%	40.2%
Recurring	13.06	13.52	8.84	9.42	67.7%	69.7%
Hardware and other	1.14	1.16	0.21	0.22	18.4%	19.0%
Total	22.04	22.57	12.55	13.26	56.9%	58.8%

Source: Company information

Retail – highlights from the first half

- Signed first deals through Global Systems integrators for ax|is fashion and concluded a major deal for Dynamics NAV retail software suite on a hosted consumption basis
- Improvement in profitability through higher software licence sales and the reduced cost of software implementations
- The 70% gross margin on software sales reflects K3's own IP content of the deals
- Although recurring revenues decreased, the gross margin increased significantly to 70.8% with the increase in the proportion of K3's IP in the revenue mix
- Cost base reductions in Holland helped to offset weak trading conditions in the Dutch fashion and retail market
- Healthy pipeline of £26.3 million (H1 2015: £28.7 million) going into H2 2016

Manufacturing and Distribution – highlights from the first half

- Gross margin improvement due to growth in hosting and efficiency improvements in the delivery of services
- Nearly 60% of segment revenue is recurring with H1 2016 recurring income increasing by 4% to £13.52 million

- SYSPRO renewal rates remained high at 98%
- The NAV and AX business closed the half year with a strong pipeline
- Hosting and managed services operation performed well with the addition of Starcom boosting delivery capabilities and which was estimated to add c. £1.5 million to sales and £0.2 million to adjusted operating profit in H1 2016
- Pipeline of £30.2 million (H1 2015: £28.0 million) going into H2 2016
- Focus on the growth potential of cloud hosting business

Estimates

Following January's trading update, we said that we would wait for the publication of the interim results before adjusting our estimates. Below, we note a number of elements to take into account.

Revenues are feeling the effects of the faster shift towards subscription-based contracts more quickly than we had anticipated. That, coupled with a weaker average Euro exchange rate against sterling in K3's fiscal H1 2016 versus the comparator period, is reflected in our reduced full year revenue estimates. We note that the Group continues to invest and that is balanced against the beneficial impact of the cost reduction initiatives that bore fruit in the half year just reported. We have also adjusted our capex assumption in FY 2016E which has a small impact on our depreciation estimates. In combination with other small changes, that feeds through to a higher level of net debt after a period of exceptionally good cash generation in FY 2015 and H1 2016. Reported PBT and EPS in FY 2016E also now include the exceptional costs of reorganisation that have been identified in the interim results.

In combination, these adjustments to our assumptions lead to the estimate changes in the table below.

Estimate changes

£m unless stated	FY16E			FY17E		
	Old	New	Change (%)	Old	New	Change (%)
Revenue	91.1	88.6	-2.7%	97.1	89.8	-7.6%
Adj EBITDA	13.1	12.8	-2.5%	15.9	14.5	-8.8%
Reported PBT	5.8	5.1	-11.3%	8.3	6.7	-18.7%
Fully adj PBT	9.5	9.1	-4.3%	11.4	9.9	-13.4%
Reported EPS (p)	14.4	12.9	-10.2%	20.5	16.8	-18.2%
Fully adj EPS (p)	24.8	23.3	-6.1%	29.7	25.8	-13.3%

Source: Progressive Equity Research estimates

SUMMARY FINANCIALS

Profit & Loss	FY-12A	FY-13A	FY-14A	FY-15A	FY-16E	FY-17E
Revenue	68.0	63.5	72.0	83.4	88.6	89.8
Adj EBITDA	12.9	7.2	9.8	10.9	12.8	14.5
Adj EBITA	11.3	5.1	7.3	8.2	10.0	10.8
Reported PBT	6.0	0.5	1.9	3.7	5.1	6.7
PBT before exceptionals and AAG	10.0	4.4	6.6	7.2	9.1	9.9
Fully adj PBT	10.0	4.4	6.6	7.2	9.1	9.9
NOPAT	9.3	4.4	6.2	7.0	8.2	9.0
Reported EPS (p)	19.8	4.2	8.1	10.1	12.9	16.8
EPS before exceptionals and AAG (p)	29.5	13.9	18.4	19.1	23.7	25.8
Fully adj EPS (p)	29.5	13.9	18.4	19.1	23.3	25.8
Dividend per share (p)	1.0	1.0	1.3	1.5	1.8	1.9
Cash flow & Balance sheet	FY-12A	FY-13A	FY-14A	FY-15A	FY-16E	FY-17E
Operating cash flow	7.3	8.0	5.4	9.6	8.8	12.2
Free Cash flow £m	1.8	1.1	(0.0)	8.4	1.1	3.8
FCF per share p	6.1	3.7	(0.0)	26.1	3.4	11.9
Acquisitions	(7.1)	(1.9)	(0.1)	(6.6)	0.0	0.0
Disposals	0.0	0.0	0.0	0.0	0.0	0.0
Shares issued	5.0	2.7	0.3	0.0	0.0	0.0
Net cash flow	(0.5)	2.0	0.1	5.5	1.1	3.8
Overdrafts / borrowings	(17.8)	(14.1)	(14.3)	(13.9)	(13.9)	(13.9)
Cash & equivalents	2.1	0.3	0.6	1.9	3.0	6.8
Net (Debt)/Cash	(15.7)	(13.8)	(13.6)	(12.0)	(10.9)	(7.1)
NAV and returns	FY-12A	FY-13A	FY-14A	FY-15A	FY-16E	FY-17E
Net asset value	46.9	51.1	52.6	53.5	57.1	62.0
NAV/share (p)	164.7	162.6	165.8	169.2	180.6	195.8
Net Tangible Asset Value	(17.9)	(14.5)	(11.4)	(8.9)	(3.2)	2.9
NTAV/share (p)	(62.8)	(46.2)	(35.9)	(28.1)	(10.2)	9.3
Average equity	42.1	49.0	51.9	53.1	55.3	59.5
Post-tax ROE (%)	13.6%	2.5%	4.9%	6.1%	7.5%	9.1%
Metrics	FY-12A	FY-13A	FY-14A	FY-15A	FY-16E	FY-17E
Revenue growth		-6.5%	13.3%	16.0%	6.2%	1.3%
Adj EBITDA growth		-44.1%	36.8%	10.3%	17.7%	13.5%
Adj EBIT growth		-55.1%	43.3%	11.6%	22.3%	8.1%
Adj PBT growth		-56.4%	50.9%	9.5%	25.9%	8.6%
Adj EPS growth		-52.9%	32.8%	4.0%	21.6%	10.6%
Dividend growth		0.0%	25.0%	20.0%	16.7%	5.7%
Adj EBIT margins	16.7%	8.0%	10.1%	9.8%	11.2%	12.0%
Valuation	FY-12A	FY-13A	FY-14A	FY-15A	FY-16E	FY-17E
EV/Sales	1.8	1.9	1.7	1.5	1.4	1.4
EV/EBITDA	9.5	16.9	12.4	11.2	9.5	8.4
EV/NOPAT	13.1	27.8	19.8	17.5	14.8	13.5
PER	11.9	25.4	19.1	18.4	15.1	13.7
Dividend yield	0.3%	0.3%	0.4%	0.4%	0.5%	0.5%
FCF yield	1.7%	1.0%	0.0%	7.4%	1.0%	3.4%

Source: Company information, Progressive Equity Research estimates

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