

K3 BUSINESS TECHNOLOGY GROUP

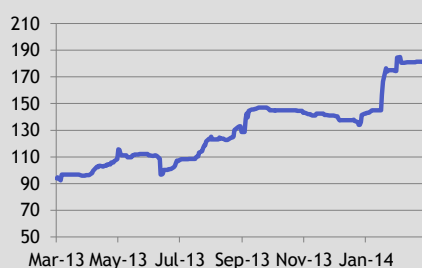
SOFTWARE & COMPUTER SERVICES

KBT.L

181p

Market Cap: £57.1m

SHARE PRICE (p)



12m high/low

185.0p/92.4p

Source: LSE Data

KEY INFORMATION

Enterprise value	£71.0m
Index/market	FTSE AIM
Next news	FY14 results, Sep 2014
Gearing	31%
Interest cover	12.2x

K3 BUSINESS TECHNOLOGY GROUP IS A RESEARCH CLIENT OF PROGRESSIVE

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Interim results confirm improved performance

Investment in growth opportunities

K3's interim results continue the positive tone of its January trading update. The Group's 9% improvement in revenue and a 24% increase in Adjusted EBITDA underline the turnaround in performance of the Microsoft UK and Managed Services Divisions – the latter moving into profitability. K3's Microsoft Dynamics AX solution (the fruit of the Gemstone project) branded as "ax|is" reports early success with £8.3 million of new contracts in both its initial fashion-sector focused form and the core ax|is solution. The announcement flags further investment and development to come. The SYSPRO and Sage Division continues to produce strong recurring revenues. The outlook statement highlights the benefits of previous investment and reiterates the longer term growth opportunities. With the announcement noting that the first half performance underpins full year forecasts, we leave our estimates of adjusted numbers unaltered.

- With a burgeoning list of ax|is reference customers, there is a clear focus on the opportunity to accelerate growth across the Retail sector and to enhance K3's international credentials.
- K3 notes that the first half of its current financial year has seen an increase in demand for AX with an attendant surge in demand for skilled AX resource. To meet that demand, the management team makes it clear that there is further 'significant' investment to come in the second half of the current financial year with more beyond that to support its expansion aims over a 3-5 year timescale.
- The SYSPRO operation has maintained high levels of recurring and encouraging levels of new business wins which increasingly involve elements of hosted services. The Sage operation is benefiting from its reorganisation and has achieved a higher profile in the market.
- The Managed Services Division's improved fortunes reflected the better performance of the Microsoft UK Division and the hosting element of new SYSPRO sales. Going forward, it should benefit further from both sources.
- Our estimates for adjusted numbers remain unchanged although estimates of reported numbers for FY14 reflect a circa £1.1 million exceptional charge. Of that, £0.58 million featured in the first half with the remaining £0.5 million - relating to changes in senior management – flagged for H2 14.

FYE JUNE	2011	2012	2013	2014E	2015E
Revenue	52.8	68.0	63.5	71.5	77.5
Adjusted EBITDA	10.6	12.9	7.3	9.8	10.5
Adjusted PBT	8.7	10.0	4.4	6.9	7.6
Adjusted EPS	22.8	24.4	13.9	17.7	19.6
EV/Sales	1.3x	1.0x	1.1x	1.0x	0.9x
EV/ Adj. EBITDA	6.7x	5.5x	9.8x	7.3x	6.8x
P/E	7.9x	7.4x	13.1x	10.2x	9.2x
Dividend yield (%)	0.4%	0.6%	0.6%	0.6%	0.7%

Source: Company Information and Progressive Equity Research estimates

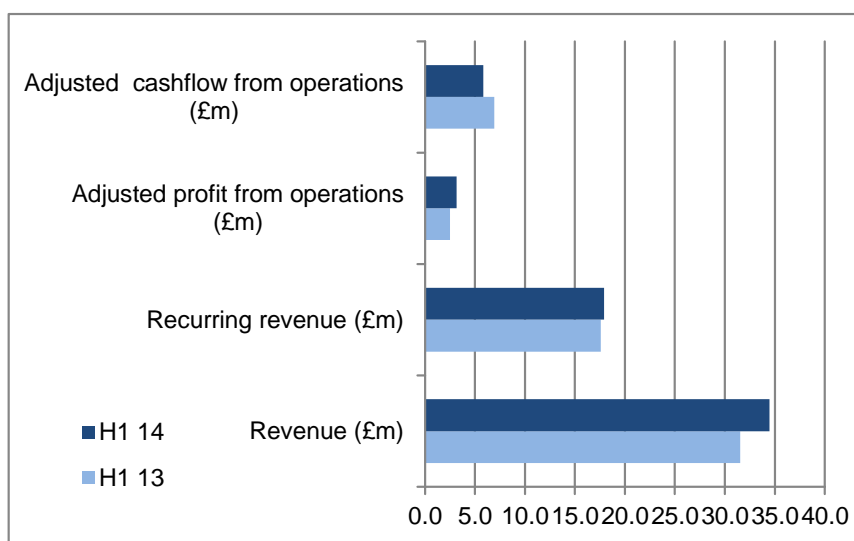
The H1 14 results

First half summary:

K3' interim results continue the theme of improving performance which was targeted in calendar 2013 as sentiment became more positive among its Retail sector clients and Gemstone started to deliver K3's AX solution. The success in harvesting some of the early fruits from previous investment and product development was trailed in the trading update in January 2014 and confirmed in these numbers. There is significant focus on the opportunity to accelerate growth across the Retail sector and to enhance K3's international credentials. To that end, management highlights further investment in the second half of the current financial year and beyond. Other main points at Group level are outlined below:

- Revenues of £34.47 million (H1 13: £31.55 million), up by 9%.
- Recurring revenues of £17.9 million (H1 13: £17.6 million), up 2, representing 52% (H1 13: 56%) of Group income.
- Adjusted profit from operations (before amortisation of acquired, acquisition costs and exceptional reorganisation costs) of £3.61 million (H1 13: £2.94 million) up by 23%.
- Adjusted profit before tax of £3.16 million (H1 13: £2.51 million), up by 26%.
- Adjusted earnings per share of 7.7p (H1 13: 6.5p), up 18%.
- As usual, no interim dividend but the Directors 'intend to propose an increased final dividend with results for the full financial year, subject to the Group's trading performance'.
- Operating cash flow of £5.85 million (H1 13: £6.92 million (representing 162% and 235% of adjusted profit from operations, respectively)
- Net debt as at 31 December 2013 of £9.91 million (H1 13: £12.32 million).
- The outlook statement notes benefits of previous investment are starting to show in results and highlights potential to accelerate sales through further investment in growth opportunities.

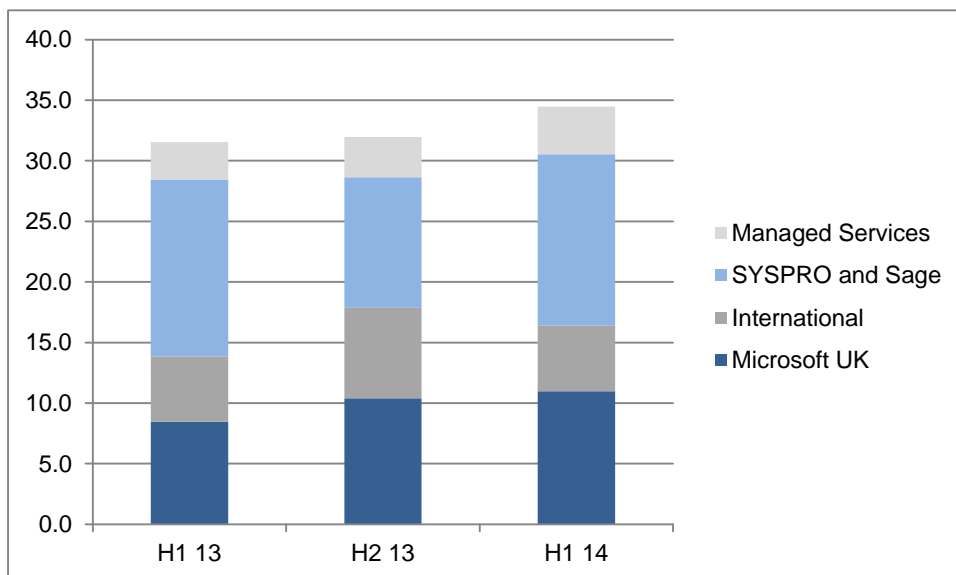
Revenue, profit and cash (£m)



Source: K3 information

The Divisions

Revenue by division (£m)



Source: K3 information

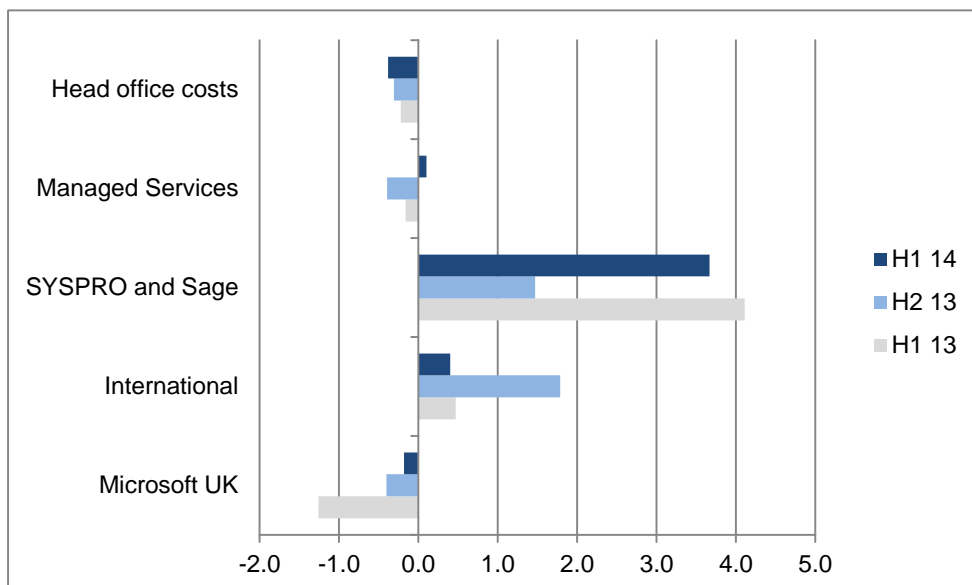
Microsoft UK Division, International Division

The early success of ax|is fashion in securing new more orders during H1 14 bodes well for the tailored AX solution which was developed by K3 through Project Gemstone. The announcement notes opportunities to expand the ax|is product elsewhere in the retail sector as well as internationally. K3 already has an international partner channel for its Pebblestone Microsoft Dynamics product, which gives it access to approximately 27 countries, and believes 'there is significant scope to extend this'. K3 already owns one of the largest Microsoft Independent Software Vendors through the Pebblestone acquisition.

Key points from H1 14 for Microsoft UK

- Combined Microsoft businesses produced revenue of £16.42 million (H1 13: £13.86 million and adjusted profit of £0.22 million (H1 13: loss of £0.79 million)).
- Microsoft UK Division produced revenue of £10.98 million (H1 13: £8.47 million and adjusted loss of £0.18 million (H1 13: loss of £1.26 million)).
- International Division produced revenue of £5.44 million (H1 13: £5.39 million and adjusted profit of £0.40 million (H1 13: £0.47 million)).
- Secured four orders worth £8.3 million for ax|is fashion and the core ax|is solution.
- Other orders – including NAV - of £1 million took total new orders in H1 14 to £9.3 million (H1 13: £0.6 million).
- Software recognised in H1 of £2.75 million (H1 13: £0.97 million).
- Recurring maintenance income of £3.89 million (H1 13: £3.59 million), up 8%.
- At 31 December 2013, the pipeline for the Division was at £40.2 million - including £4.8 million from recent wins which have yet to be delivered (31 December 2012: £36.0 million).

Adjusted profit by division (£m)



Source: K3 information

K3 notes that the first half of its current financial year has seen a 'significant increase' in demand for AX with an attendant surge in demand for skilled AX resource. To meet that demand, the management team makes it clear that there is further 'significant' investment to come in the second half of the current financial year with more beyond that to support its expansion aims over a 3-5 year timescale– including recruitment and training. It's clear that the Group continues to see significant growth potential in its Microsoft AX retail solutions.

Key points from H1 14 for International

- A 'challenging' half year in the Netherlands due to the Dutch economy as customers remain reluctant to commit to new deals.
- Inter IKEA Systems encouraging with good levels of services income.
- Revenues of £5.44 million (H1 13: £5.39 million).
- Adjusted profit from operations of £0.40 million (H1 13: £0.47 million) reflecting investment in Dynamics AX and recruitment.
- Software revenues up 14% to £0.8 million but services revenues were flat at £2.4 million.
- Margin of 49.5% (H1 13: 45.3%).
- Order wins of £0.79 million (H1 13: £0.53 million).
- Pipeline of £5.2 million of orders (H1 13: £7.1m).
- The ISV Channel Management business performed in line with prior year and continued to work closely with the UK Division on the ax|is product.
- Investment will be ongoing in the international distribution channel.
- The Unisoft business is performing in line with management expectations.

SYSPRO and Sage Division

The SYSPRO and Sage Division included around £5.5 million of SYSPRO annual maintenance and support income in its first half revenues of £14.12 million (down a touch following a small disposal in May 2013). New deals signed in the first half were up 29% to £2.64 million reflecting, inter alia, SYSPRO upgrades and Sage's X3 product.

Key points from H1 14 for SYSPRO and Sage

- Revenue of £14.12 million (H1 13: £14.60 million). Excluding a small disposal in May 2013 disposal, like-for-like sales increased by 5%.
- Adjusted profit from operations of £3.67 million (H1 13: £4.11 million).
- Increased cost base reflected investment in sales, marketing and finance resource in the Sage business.
- Software sales of £1.93 million (H1 13: £1.92 million).
- Services revenue of £2.62 million (H1 13: £2.52 million).
- Maintenance and support revenues of £9.4 million (H1 13: £8.8 million).
- SYSPRO maintenance and support levels remained strong with a 97% renewal rate (H1 13: 98%).
- Overhead costs of £5.4 million (H1 13: £5.1 million).
- Pipeline of £14.8 million (H1 13: £14.0 million).

Managed Services Division

The Managed Services Division's improved fortunes reflected the better performance of the Microsoft UK Division and the hosting element of new SYSPRO sales. Going forward, it should benefit further from both sources.

Key points from H1 14 for Managed Services

- Revenues of £3.93 million (H1 13: £3.43 million).
- Eliminated H2 13 losses. Adjusted profit from operations of £0.1m (H1 13: loss of £0.06 million).
- The hosting business benefiting from new management and a significant reduction in the cost base.
- Deal wins aided by the ability to host multi-site overseas customers.

Estimates

Our estimates for adjusted numbers remain unchanged although estimates of reported numbers for FY14 reflect a circa £1.1 million exceptional charge. Of that, £0.58 million, relating to reorganisations in the Managed Services, Retail and Sage businesses, occurred in the first half. The remaining £0.5 million - relating to changes in senior management – is flagged for H2 14. Although we are leaving our estimates essentially unchanged at this point, we shall watch for any guidance on the impact of the balance between improving revenues and further investment spend.

Financial summary

Year ended Jun	FY-11	FY-12	FY-13	FY-14	FY-15
	£m	£m	£m	£m	£m
Profit & Loss	Act	Act	Act	Est	Est
Revenue £m	52.8	68.0	63.5	71.5	77.5
Adj EBITDA £m	10.6	12.9	7.3	9.8	10.5
Adj EBIT £m	9.6	11.4	5.2	7.8	8.5
Reported PBT	4.9	6.0	0.5	2.3	4.1
PBT before exceptionals and AAG	8.7	10.0	4.4	6.9	7.6
Fully adj PBT	8.7	10.1	4.4	7.0	7.7
NOPAT £m	6.7	8.0	3.6	5.4	6.0
Reported EPS	16.7	19.8	4.2	5.9	10.5
EPS before exceptionals and AAG	22.7	24.3	10.4	17.6	19.4
Fully adj EPS	22.8	24.4	13.9	17.7	19.6
Dividend per share p	0.8	1.0	1.0	1.1	1.2
Cash flow & Balance sheet					
Operating cash flow	5.6	7.3	8.0	8.8	9.5
Free Cash flow £m	2.4	3.6	3.9	4.2	4.9
FCF per share p	8.9	12.4	13.2	13.3	15.6
Capex	-2.1	-3.2	-4.6	-3.5	-3.0
Acquisitions	-5.4	-7.1	-1.9	-0.4	-0.4
Net cash flow	-4.2	-5.4	-0.8	1.9	3.1
Shares issued	0.2	5.0	2.7	0.0	0.0
Net cash	-15.5	-15.7	-13.8	-11.9	-8.8

Metrics	FY-11	FY-12	FY-13	FY-14	FY-15
Revenue growth	20.4%	28.7%	-6.5%	12.6%	8.4%
Adj EBITDA growth	27.4%	22.4%	-43.9%	34.5%	7.5%
Adj EBIT growth	28.8%	18.4%	-54.7%	50.4%	9.5%
Adj PBT growth	31.5%	15.7%	-56.0%	56.9%	10.5%
Adj EPS growth	22.7%	7.2%	-43.2%	27.9%	10.5%
Dividend growth	50.0%	33.3%	0.0%	10.0%	9.1%
Adj EBIT margins	18.2%	16.8%	8.1%	10.9%	11.0%
Operating cash conversion	53%	56%	110%	90%	90%
Capex/Depreciation	218%	206%	219%	175%	150%

Valuation	FY-11	FY-12	FY-13	FY-14	FY-15
EV/sales	1.3	1.0	1.1	1.0	0.9
EV/EBITDA	6.7	5.5	9.8	7.3	6.8
EV/NOPAT	10.5	8.9	19.6	13.0	11.9
PER	7.9	7.4	13.1	10.2	9.2
Dividend yield	0.4%	0.6%	0.6%	0.6%	0.7%
FCF yield	4.9%	6.9%	7.3%	7.3%	8.6%

Source: K3 information and Progressive Equity Research estimates

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