

K3 Business Technology

Preliminary results

In fashion

Software & comp services

K3 reported strong revenue growth in FY14 as demand recovered in the majority of its business lines. The company is seeing strong demand for its ax |is solution in the UK and has started to sell the solution through its International division. Support from Microsoft and discussions with global system integrators highlight the opportunity outside of Europe.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
06/13	63.5	4.4	14.1	1.00	15.2	0.5
06/14	72.0	6.6	18.5	1.25	11.6	0.6
06/15e	79.7	8.0	20.4	1.31	10.5	0.6
06/16e	84.2	9.9	25.3	1.38	8.5	0.6

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

FY14 results: ax |is momentum continues

FY14 group revenues grew 13.3% y-o-y, with 17.3% y-o-y growth in H214. K3 started to receive orders for its ax |is solution in H114 – positive momentum has continued with further order wins in H214 and a promising pipeline. In addition, the Dynamics NAV business returned to growth, and restructuring of the Sage business has stimulated a pick-up in orders in H2. Operating margin improved to 10.2% from 8.1% a year ago, despite increased investment in product development and sales and delivery headcount, and Microsoft UK returned to profitability in H214 (it was last profitable in H212).

Outlook and changes to forecasts

Management expects to drive improving profitability while still continuing to invest in the business, and expects to reduce net debt by at least £3m in FY15. K3 intends to continue investing in product development across all business lines to ensure longer-term growth. The ax |is solution is the key driver of growth in the Microsoft UK business, and as the reseller channel is developed, is also likely to drive growth in the International business. We forecast revenue growth in all divisions in FY15 and FY16, raising our FY15e revenue by 6.7%. As K3 continues to invest in product and headcount, our FY15e operating profit falls by 5.6% (10.7% margin); on a lower tax rate, our FY15e normalised EPS falls by 3%. We forecast a fall in net debt to £10.7m by the end of FY15e and £6.3m by the end of FY16e.

Valuation: ax |is adoption key to upside

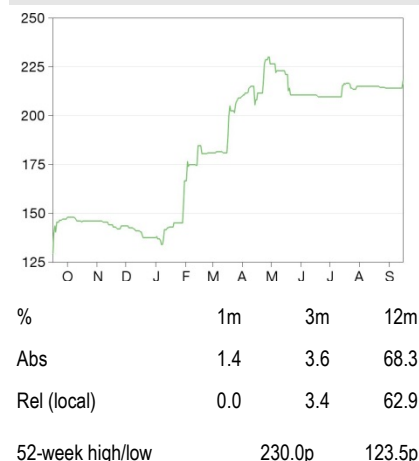
The stock is trading on a P/E of 10.5x FY15e and 8.5x FY16e and an EV/sales multiple of 1.0x FY15e. This is still at a material discount to its peers (sub-£200m market cap UK software current year P/E 19.5x, EV/sales 2.6x). With evidence of sustained demand for the new ax |is solution, continued debt reduction and a return to growth in the International division, we see scope for the share price to start to reduce the discount to peers. The wider global opportunity for ax |is could provide further upside potential in the longer term.

16 September 2014

Price 214.2p
Market cap £68m

Net debt (£m) at end FY14	13.6
Shares in issue	31.7m
Free float	77%
Code	KBT
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



Business description

K3 Business Technology provides Microsoft- and Sage-based ERP solutions and managed services to SMEs in the retail, distribution and manufacturing sectors.

Next events

H115 trading update January 2015

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Review of FY14 results

Exhibit 1: FY14 results highlights			
£000	FY14e	FY14a	Difference
Microsoft UK	25,980	25,255	-2.8%
International	13,315	12,526	-5.9%
SYSPRO & Sage	25,120	26,017	3.6%
Managed Services	7,930	8,152	2.8%
Revenues	72,345	71,950	-0.5%
Microsoft UK	45	647	1337.8%
International	2,211	1,537	-30.5%
SYSPRO & Sage	5,320	5,070	-4.7%
Managed Services	200	432	116.0%
Head office costs	(666)	(358)	-46.2%
Normalised operating profit	7,110	7,328	3.1%
Operating margin	9.8%	10.2%	0.4%
Normalised PBT	6,360	6,623	4.1%
Normalised net income	4,860	5,874	20.9%
Reported EPS (p)	5.6	8.1	45.2%
Normalised EPS (p)	15.3	18.5	21.1%
Net debt	12,298	13,628	10.8%

Source: K3 Business Technology

Microsoft UK

Revenue grew 33.9% y-o-y, with 29.6% growth in H114 and stronger growth in H214 of 37.4%. The division moved from an adjusted loss of £1.66m in FY13 to an adjusted profit of £0.65 in FY14 (2.6% margin for full year, 5.8% in H214). Services revenues increased 51% to £8.9m, as the division concentrated on implementing recently won contracts. Software revenues saw growth of 53% to £5.57m as customers signed up for the ax |is solution. We note that in some cases, software revenues are earned via a Microsoft Enterprise Agreement, whereby K3 receives net commission for the sale rather than recording the full value of the software in revenues, and the cost to acquire that software from Microsoft in the cost of sales. The company estimates that if all revenues had been recognised in the traditional way, software revenues would have been £1.16m higher.

Reflecting the high level of services revenue, while recurring support and maintenance revenues grew 14% y-o-y, they fell to 38% of total, from 44% in FY13. Recurring revenues should grow as new contracts currently in implementation phase go live.

By the end of FY13, the company had won several pilot orders for ax |is and during FY14 won nine major contracts worth £12.63m for the solution. New orders across the division in FY14 (including Microsoft Dynamics NAV solutions) totalled £15.4m versus £6.87m in FY13. £6.16m of new orders were signed in H2, including two pilots for ax |is. The company noted that demand for the Dynamics NAV solution had picked up, with a return to growth for that part of the business in FY14. Two major contracts worth £1.3m were signed, and since year end a further £0.86m contract was won. To ensure there is an upgrade path for existing NAV customers, the company is investing in additional functionality.

The company noted that the cost of delivering the new solution has been affected by the shortage of skilled Dynamics AX resource. To reduce the cost (both in terms of recruitment fees and the premium commanded by AX-skilled staff) and to get access to resources, the company has increased the level of near-shoring (Malta, Western Ukraine). The company has also set up an in-house training scheme.

Dynamics AX contracts tend to be larger than Dynamics NAV contracts and tend to take longer to implement. From a software point of view, this could lead to lumpier revenues as demand for the ax |is solution grows.

The acquisition of RTL is being integrated with the division's Dynamics RMS business line.

International

Revenues fell 2.6% y-o-y, as the slow recovery of the Dutch fashion and retail market dampened demand. Adjusted profit margin fell from 17.6% to 12.3% – the division made investments in the Dynamics AX product, which is now being sold in this division for the first time. This includes an increase in sales and marketing personnel to build the channel team and to prepare the Dutch business to start to sell Dynamics AX in addition to its existing Dynamics NAV solution. The division's ISV channel has started to see interest in the ax |is solution.

The Inter IKEA Systems BV relationship is still strong, supporting good levels of service revenues and with further potential business likely. The Unisoft business is trading in line with expectations. Although the market remains difficult, the business is seeing interest in its RVE POS product.

Software sales increased 19% y-o-y to £1.93m whereas services revenues fell 3% to £4.64m. The division received major order wins worth £3.2m in the year (up from £1.13m in FY13), with particularly strong growth in H2.

SYSPRO and Sage

Revenues grew 2.5% y-o-y, with a 3.3% decline in H114 shifting into 10.4% growth in H214. Adjusted profit margin fell year-on-year, from 22.0% to 19.5%, due to a combination of weaker sales of Sage products in H114, and investment in resources in both the SYSPRO and Sage businesses.

Software sales grew 30% y-o-y to £5.0m and services revenues increased 6% to £5.56m. Recurring revenues fell 5% y-o-y to £15.12m (58% of sales) reflecting the disposal of a small non-core Sage business in May 2013.

SYSPRO maintenance and support achieved a 97% renewal rate in the year (FY13: 98%). SYSPRO won 14 new orders worth £2.34m in FY14, compared to 10 new orders worth £1.77m in FY13. The majority of new deals include an extended period of maintenance. The company noted that within the SYSPRO business, K3 generated c £1m in revenue from own-IP solutions, and wants to continue to invest in product development. The business is investing in new staff to ensure continuity when several employees reach retirement age.

The Sage business had a slow start to the year, but after re-organising the delivery and support functions and recruiting a new sales director, the business saw a much stronger second half. The business signed 87 deals worth £3.7m in FY14, up from 60 deals worth £2.05m in FY13. H2 saw particular strength in sales of the X3 solution. K3 has developed a standard implementation template for X3 that enables delivery in less than 60 man days – the company believes this is driving strong demand for the product.

Managed Services

Revenue grew 27% y-o-y with strong growth in both halves. The division moved into profitability, reporting an adjusted profit margin of 5.3% (H1 2.5%, H2 7.9%). Recurring revenue grew 16% y-o-y to make up 68% of revenues. Hosting made up 52% of recurring revenue, falling from 61% a year ago as one large hosting contract was lost in H214 (K3's customer had in turn lost a large customer). New SYSPRO and AX contracts are now written with hosting as the default delivery model.

Group

The group finished the year with net debt of £13.6m, as previously announced in the July trading update. Gross debt includes a £3.6m overdraft and secured bank loans of £9.96m. The debt facility was renegotiated in August and extended to August 2017 on similar terms to the previous facility.

The group incurred exceptional costs of £1.7m, made up of reorganisation costs, restructuring of recent acquisitions and changes in senior management.

The normalised tax rate was 11%, with the company benefiting from R&D tax credits.

The company announced an increase in the dividend to 1.25p (+25% y-o-y), higher than our 1.05p forecast.

Outlook and changes to forecasts

Management is concentrating on driving margins up and expects progressive improvement in the near term, even while investing for further growth. The Microsoft UK and International divisions are working together on global initiatives to generate additional IP, cost-effective resourcing and improved channels to market, particularly for ax |is. The company is aiming to tailor the existing ax |is template for other retail markets, and wants to make use of its reseller channel to monetise this IP.

Microsoft is keen for K3 to sell the ax |is solution in new territories and K3 and Microsoft sales teams are working together on this. K3 is also talking to global system integrators such as Cap Gemini, IBM, Hitachi and PwC with a view to them reselling ax |is.

The company does not expect to incur any material exceptional costs in FY15.

We discuss below the changes to our forecasts by division:

- **Microsoft UK** had a pipeline of £37.9m at the end of FY14 plus a further £7.18m in orders due for delivery in FY15. Based on the strong pipeline and backlog, we have increased our revenue forecast for FY15 by 10% (growth 16.5% y-o-y) and introduce a growth forecast of 6.5% for FY16. We forecast improving operating margins in FY15 and FY16, although we note that the cost of resourcing AX projects has limited our profit upgrade.
- **International** had a prospects pipeline (excluding longer-term potential business with IKEA) of £6.7m at year-end, up from £5.2m a year ago. As the company is planning to sell AX product through this business, we forecast 8.5% revenue growth in FY15 moderating to 5.4% in FY16. We have factored in higher costs as the division invests in resources in readiness for selling AX solutions.
- **SYSPRO and Sage:** SYSPRO had a £2.8m pipeline at the end of FY14, down from £3.4m a year ago. The pipeline for the whole division stood at £17.0m at year end, up from £14.8m a year ago. We forecast 5% growth in FY15, reflecting the reinvigorated Sage business, and 3.5% in FY16. Our operating profit forecasts take account of the increased investment in headcount and product development.
- **Managed services:** the hosting business had a pipeline of £4.1m at year end, up from £3.37m a year ago. Based on stronger than expected revenue growth and profitability, we have increased our FY15 forecasts and introduce an FY16 revenue growth rate of 15.0% and an adjusted operating margin of 9.3%.

The company is planning to change its reporting format to industry sector-based (retail, manufacturing & distribution, IP) rather than by product; our forecasts are in the existing format.

Exhibit 2: Changes to forecasts

£000				Old	New		New	Growth		
	FY14e	FY14a	Difference	FY15e	FY15e	Change	FY16e	FY14a	FY15e	FY16e
Microsoft UK	25,980	25,255	-2.8%	26,759	29,422	10.0%	31,329	33.9%	16.5%	6.5%
International	13,315	12,526	-5.9%	13,714	13,591	-0.9%	14,329	-2.6%	8.5%	5.4%
SYSPRO & Sage	25,120	26,017	3.6%	25,874	27,318	5.6%	28,274	2.5%	5.0%	3.5%
Managed Services	7,930	8,152	2.8%	8,327	9,375	12.6%	10,264	27.1%	15.0%	9.5%
Revenues	72,345	71,950	-0.5%	74,674	79,705	6.7%	84,196	13.3%	10.8%	5.6%
								Margin		
Microsoft UK	45	647	1337.8%	1,168	1,775	51.9%	2,417	2.6%	6.0%	7.7%
International	2,211	1,537	-30.5%	2,345	1,774	-24.3%	2,159	12.3%	13.1%	15.1%
SYSPRO & Sage	5,320	5,070	-4.7%	5,308	4,587	-13.6%	5,299	19.5%	16.8%	18.7%
Managed Services	200	432	116.0%	709	870	22.7%	1,026	5.3%	9.3%	10.0%
Head office costs	(666)	(358)	-46.2%	(470)	(450)	-4.3%	(500)			
Normalised operating profit	7,110	7,328	3.1%	9,060	8,556	-5.6%	10,402			
Operating margin	9.8%	10.2%	0.4%	12.1%	10.7%	-1.4%	12.4%			
Normalised PBT	6,360	6,623	4.1%	8,510	7,956	-6.5%	9,902			
Normalised net income	4,860	5,874	20.9%	6,704	6,522	-2.7%	8,114			
Reported EPS (p)	5.6	8.1	45.2%	13.1	11.8	-9.5%	17.1			
Normalised FD EPS (p)	15.3	18.5	21.1%	21.0	20.4	-3.0%	25.3			
Net debt	12,298	13,628	10.8%	9,206	10,657	15.8%	6,275			

Source: K3 Business Technology, Edison Investment Research

Exhibit 3: Financial summary

	£000s	2010*	2011	2012	2013	2014	2015e	2016e
Year end 30 June		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS								
Revenue		59,783	52,800	67,961	63,513	71,950	79,705	84,196
Cost of Sales		(22,460)	(23,486)	(28,491)	(30,375)	(32,990)	(34,273)	(36,204)
Gross Profit		37,323	29,314	39,470	33,138	38,960	45,432	47,992
EBITDA		10,327	10,574	12,942	7,261	9,861	11,356	13,502
Operating Profit (before am of acq. intang. and except.)		9,013	9,633	11,405	5,164	7,328	8,556	10,402
Amortisation of acquired intangibles		(2,892)	(2,826)	(3,586)	(3,182)	(2,989)	(3,100)	(3,100)
Share-based payments		39	(52)	(72)	(70)	(27)	(70)	(70)
Other		0	(942)	(395)	(727)	(1,722)	0	0
Operating Profit		6,160	5,813	7,352	1,185	2,590	5,386	7,232
Net Interest		(1,365)	(905)	(1,309)	(723)	(705)	(600)	(500)
Profit Before Tax (norm)		7,620	8,728	10,096	4,441	6,623	7,956	9,902
Profit Before Tax (FRS 3)		4,767	4,908	6,043	462	1,885	4,786	6,732
Tax		(1,018)	(428)	(319)	780	675	(1,034)	(1,287)
Profit After Tax (norm)		5,770	7,108	8,591	4,165	5,874	6,522	8,114
Profit After Tax (FRS 3)		3,749	4,480	5,724	1,242	2,560	3,752	5,444
Average Number of Shares Outstanding (m)		24.6	25.7	28.2	29.2	31.4	31.7	31.8
EPS - normalised (p)		23.5	27.7	30.4	14.3	18.7	20.6	25.6
EPS - normalised fully diluted (p)		23.4	27.0	29.7	14.1	18.5	20.4	25.3
EPS - FRS 3 (p)		15.2	17.5	20.3	4.3	8.1	11.8	17.1
Dividend per share (p)		0.75	0.75	1.00	1.00	1.25	1.31	1.38
Gross Margin (%)		62.4	55.5	58.1	52.2	54.1	57.0	57.0
EBITDA Margin (%)		17.3	20.0	19.0	11.4	13.7	14.2	16.0
Operating Margin (before GW and except.) (%)		15.1	18.2	16.8	8.1	10.2	10.7	12.4
BALANCE SHEET								
Fixed Assets		48,602	59,457	68,325	69,398	67,067	64,469	61,571
Intangible Assets		13,176	17,635	21,255	21,040	20,040	17,840	15,340
Tangible Assets		1,393	1,993	2,722	2,927	2,439	2,041	1,643
Goodwill		33,467	39,082	43,540	44,610	43,952	43,952	43,952
Other		566	747	808	821	636	636	636
Current Assets		14,808	23,456	32,418	25,523	29,535	33,423	36,318
Stocks		0	0	0	0	0	0	0
Debtors		14,439	22,642	30,322	25,251	28,888	32,319	34,832
Cash		369	814	2,096	272	647	1,104	1,486
Current Liabilities		(19,510)	(29,300)	(48,043)	(39,272)	(40,278)	(38,554)	(33,954)
Creditors		(5,491)	(7,874)	(8,797)	(5,842)	(7,218)	(7,994)	(8,444)
Other Creditors		(9,719)	(16,628)	(21,468)	(19,379)	(18,799)	(18,799)	(17,749)
Short term borrowings		(4,300)	(4,798)	(17,778)	(14,051)	(14,261)	(11,761)	(7,761)
Long Term Liabilities		(12,457)	(16,371)	(5,797)	(4,524)	(3,719)	(3,705)	(3,705)
Long term borrowings		(7,051)	(11,502)	0	(32)	(14)	0	0
Other long term liabilities		(5,406)	(4,869)	(5,797)	(4,492)	(3,705)	(3,705)	(3,705)
Net Assets		31,443	37,242	46,903	51,125	52,605	55,632	60,230
CASH FLOW								
Operating Cash Flow		7,331	5,640	7,284	8,022	5,352	8,702	10,388
Net Interest		(1,303)	(947)	(839)	(820)	(848)	(600)	(500)
Tax		(1,637)	(1,368)	(1,312)	(1,217)	290	(1,434)	(1,787)
Capex		(1,638)	(2,055)	(3,160)	(4,613)	(4,487)	(3,302)	(3,302)
Acquisitions/disposals		(2,856)	(5,407)	(7,132)	(1,917)	(129)	0	0
Financing		1,434	174	5,026	2,677	277	0	0
Dividends		(247)	(64)	(214)	(286)	(316)	(395)	(417)
Net Cash Flow		1,084	(4,027)	(347)	1,846	139	2,971	4,382
Opening net debt/(cash)		13,012	10,982	15,486	15,682	13,811	13,628	10,657
HP finance leases initiated		0	0	0	0	0	0	0
Other		946	(477)	151	25	44	0	0
Closing net debt/(cash)		10,982	15,486	15,682	13,811	13,628	10,657	6,275

Source: K3 accounts, Edison Investment Research. Note: *18-month period.

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