19 March 2019

K3 BUSINESS TECHNOLOGY GROUP

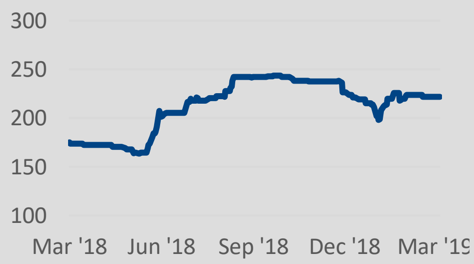
SOFTWARE & COMPUTER SERVICES

KBT.L

222p

Market Cap: £95.2m

SHARE PRICE (p)



12m high/low	243.5p/164p

Source: LSE Data

KEY INFORMATION

Enterprise value	£99.5m
Index/market	AIM
Next news	AGM, 22 May 2019
Gearing	4.5%
Interest cover	0.8x

K3 BUSINESS TECHNOLOGY GROUP IS A RESEARCH CLIENT OF PROGRESSIVE

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Strong FY18 delivery – well poised for FY19

K3 has achieved a return to profitability – delivering an adjusted operating profit of some £4.6m – and marking a material turnaround from the difficulties of a couple of years ago. The group continues its march to higher levels of own-intellectual property sales, and towards a greater level of recurring income. We make no material changes to FY19E estimates, and introduce FY20 forecasts for the first time.

- **Results announced** K3 has announced results for the year to November 2018 – revenues of £83.3m were a touch shy of our £85.7m estimate, but more importantly, profitability was ahead of our forecasts - £4.6m vs our £4.1m estimate for adjusted EBITA. Net debt had been detailed at the time of the trading updated in December – this came in a £0.6m vs the £0.7m previously mentioned.

- **Additional detail** The release provides additional detail – this is described further overleaf. The group has seen improvements in gross margin (up from 51.6% to 52.7% overall, and even more materially from 64.1% to 73.6% with Own IP). The K3 Imagine platform has been launched, a major part of the Own IP strategy, and early FY19E sales are described as "encouraging".

- **FY19E and FY20E forecasts** We make no changes to our FY19E estimates for adjusted EBITA or net cash, although we reflect the modest miss in FY18 revenue by reducing FY19E by some £2m (from £90m to c.£88m.

  We introduce estimates for FY20E for the first time – these are as shown below; our FY20E revenue is roughly flat on FY19E as we expect the group to continue de-emphasising non-core revenue and focusing on high-margin own-IP sales. This change of mix accounts for the ongoing increase in margins despite roughly-static sales. We hope, given that revenues have shown a modest H2 vs H1 progression, that our revenue estimates will ultimately be proven conservative.

The results announced today paint a clear picture – the business continues to evolve in a positive direction, progress is being made in the more-valuable aspects of the group's behaviour, and the focus on customer opportunity and own IP continues to bear fruit.

FYE NOV (£M)	2016(I)	2017 (II)	2018	2019E	2020E
Revenue	89.2	118.2	83.3	88.0	88.0
Adj EBITA	9.5	(1.7)	4.6	5.3	6.0
Fully adj PBT	8.8	(3.0)	4.0	5.3	6.0
Fully adj dil EPS (p)	22.9	(7.7)	6.8	9.2	10.3
EV/Sales (x)	1.1	0.8	1.2	1.1	1.1
EV/EBITDA (x)	7.8	40.2	12.3	10.6	9.7
PER (x)	9.7	N/A	32.5	24.3	21.5

Source: Company Information and Progressive Equity Research estimates

Note: (I) FY2016 is a June year end; (II) FY2017 is 17 months to November 2017

Additional detail

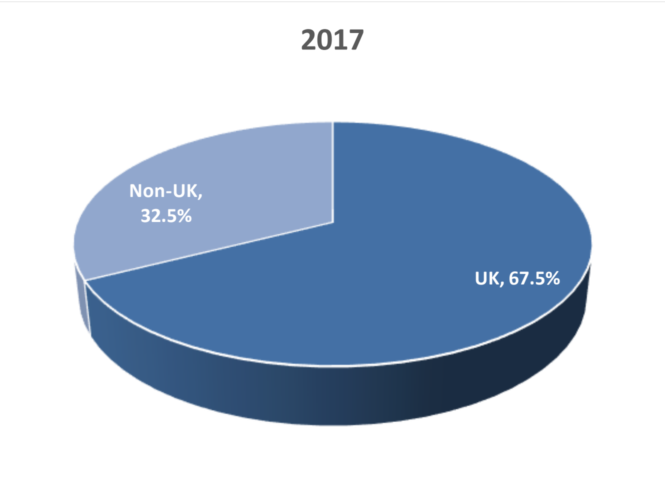
The 2018 results statement includes a number of detailed comments around recent performance and the outlook for 2019 and beyond. The key elements of the message, in our view, are :

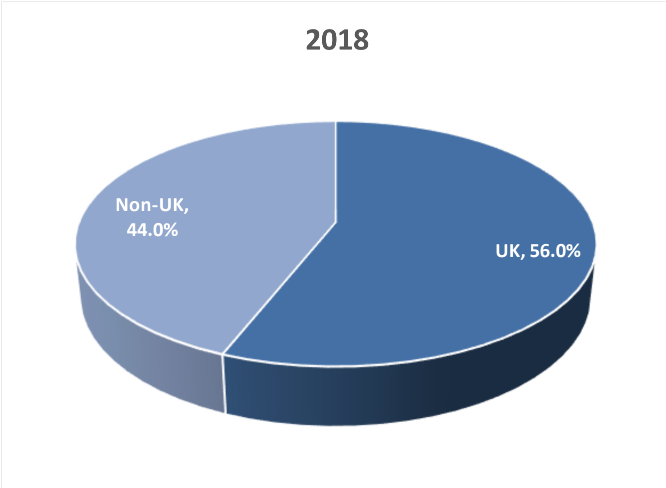
- K3 Fashion continuing to sell well to an international customer base of retail clients, based on Microsoft Dynamics technology
- K3 Imagine, the new bedrock of the group's platform, launched and seeing good initial traction
- Solid delivery from the other areas of the group – good levels of recurring margin from SYSPRO and Sage businesses, and the IKEA relationship continues to expand, especially in the APAC region

Geographic extension

A major achievement of the past two years' work has been the rapid internationalisation of the group – at a time when domestic UK demand, especially in the challenged retail sector, is coming under significant investor scrutiny, the group's expanding overseas footprint is an increasingly valuable attribute. The charts below demonstrate how quickly and dramatically this globalisation is being achieved :

OVERSEAS REVENUES AS PERCENTAGE OF TOTAL





Source: Company information

Launch of K3 Imagine

Although we have previously commented on the K3 Imagine product launch, it is worth briefly recapping on the aspects of the platform and what it is aiming to achieve. The Imagine platform is a material part of the group's push for additional own-IP software sales, which will bring higher levels of gross margin (see below) and better long-term customer relationship and retention. The key aspects of the platform are shown below:

- Software-as-a-Service model offering, "cloud native" and delivering a wide range of flexible modules to retail customers looking for an innovative and scalable solution
- Ease of integration – simple to implement alongside existing infrastructure (hardware and software) allowing easy API – and full platform – access, crucially not requiring customers to "rip and replace" other investments
- Ready-built functionality (such as mobilePOS and other systems) available "out of the box" but also allowing flexible adaptation to specific user and customer requirements
- Additional applications within K3 Imagine will be developed and sold alongside customer relationships

Financial performance – focus on Gross Margin

As described above, a key part of the value case for K3 relies on the shift towards higher-margin own-intellectual-property software sales. The evidence from FY18 is that the group is moving in the right direction, considering both overall gross profitability levels and the levels of gross profit within the own-IP software unit. Comparison with the 17-month FY17 period is not perfect, since that timeframe covered two "renewal" seasons with the resold SYSPRO platform, which distorts the overall margin picture. Nevertheless, the group provided figures for the own-IP unit which also (and in fact more clearly) demonstrate the point :

GROSS MARGIN PROGRESSION

Source: Company information

Other detail

It is difficult to draw too many specific comparative conclusions from the FY18 results, because the comparable period was 17 months in duration, and included two “seasons” of SYSPRO renewal – rendering direct comparison meaningless, and even “per month” metrics potentially misleading. Nevertheless, there were a number of other salient points within the FY18 results which stand out, even allowing for this difference between the reporting periods :

- K3 Fashion continues to sell well – with 11 new customer deals, compared to only 7 during the much longer (17 month) period to November 2017. These deals were also, on average, of a larger size – suggesting good ongoing traction in this market.
- The restructuring of the various Microsoft Dynamics-focussed businesses into one unit (for Dynamics AX, NAV and CRM products) was successfully executed, bringing greater operating efficiency and reducing costs.
- Own IP software licence sales rose from £2.9m in 17 months to November 2017, to £4.3m in the twelve months to November 2018…this clearly suggests material traction within the K3 Fashion suite and bodes well for longer-term margin generation.
- Net debt was dramatically reduced, in line with our expectations, to just £0.6m at the period end. This represents a major achievement for the group, and we forecast a move to net cash during the course of FY19E.

FY18 performance and changes to estimates

The FY18 results were largely in line with expectations, albeit fractionally light in terms of revenue, but moderately well ahead at the Adjusted EBITA level. Adjusted EPS was slightly shy of our estimate due to tax treatment on adjusting items, but not a cause for concern given the strength in EBITA. We make the changes to FY19E estimates as shown in the table below and introduce FY20E estimates for the first time. In setting these new numbers, we take note of the migration to SaaS-delivering (and therefore slow revenue recognition), but also the improving margin mix, allowing for growing EBITA on roughly-static revenues. Hopefully both our EBITA and sales estimates will prove cautious over time.

FY18 DELIVERY AND CHANGES TO ESTIMATES

	FY 2018			FY 2019E			FY 2020E
£m unless stated	**Est**	**Act**	**Diff (%)**	**Old**	**New**	**Change (%)**	**New**
Revenue	85.7	83.3	-2.8%	90.0	88.0	-2.2%	88.0
Adj EBITA	4.1	4.6	13.4%	5.3	5.3	0.5%	6.0
Reported PBT	0.9	0.0	-98.1%	2.6	2.7	2.6%	3.4
Fully adj PBT	3.8	4.0	5.0%	5.3	5.3	1.3%	6.0
Fully adj dil EPS (p)	7.3	6.8	-5.9%	10.1	9.2	-9.0%	10.3
Net (debt)/cash	-0.6	-0.6	3.0%	2.5	2.5	0.0%	5.8

Source: Progressive Equity Research estimates

Summary and conclusion

Overall, the FY18 outcome represents a very major turnaround, achieved from a difficult starting position, against an arguably challenging macroeconomic backdrop, and in a rapid timeframe.

The result for the year shows some of the potential within the group, demonstrating some major client wins, a good degree of product evolution, and the group's ability to rely on existing (and highly recurring) revenue streams while these other aspects evolve to maturity.

We continue to believe that K3 remains well placed – in fact, perhaps better-placed than we had previously realised – within its chosen market segment. We look forward to delivery during FY19 on some of this promise, and to the years further in the future when the SaaS-based and "cloud-native" intellectual property should be able to demonstrate its true worth.

Financial Summary: K3 Business Technology Group

Year end: November (£m unless shown)

PROFIT & LOSS	**2016(i)**	**2017 (ii)**	**2018**	**2019E**	**2020E**
Revenue	89.2	118.2	83.3	88.0	88.0
Adj EBITDA	12.8	2.5	8.1	9.4	10.3
Adj EBITA	9.5	(1.7)	4.6	5.3	6.0
Reported PBT	4.5	(16.1)	0.0	2.7	3.4
Fully adj PBT	8.8	(3.0)	4.0	5.3	6.0
NOPAT	7.8	(1.4)	3.9	4.4	5.0
Reported EPS (p)	12.3	(35.3)	(1.1)	5.0	6.3
Fully adj dil EPS (p)	22.9	(7.7)	6.8	9.2	10.3
Dividend per share (p)	1.8	1.4	1.5	1.7	1.8

CASH FLOW & BALANCE SHEET	**2016(i)**	**2017 (ii)**	**2018**	**2019E**	**2020E**
Operating cash flow	5.5	5.9	8.2	7.2	8.0
Free Cash flow	(2.0)	(3.1)	3.4	3.1	3.3
FCF per share (p)	(4.7)	(7.2)	7.9	7.3	7.8
Acquisitions	(7.4)	(1.0)	0.0	0.0	0.0
Disposals	0.0	0.0	0.0	0.0	0.0
Shares issued	13.2	8.4	0.0	0.0	0.0
Net cash flow	3.8	4.3	3.4	3.1	3.3
Overdrafts / borrowings	(11.6)	(6.2)	(7.5)	(7.5)	(7.5)
Cash & equivalents	2.8	1.9	6.9	10.0	13.4
Net (Debt)/Cash	(8.9)	(4.3)	(0.6)	2.5	5.8

NAV AND RETURNS	**2016(i)**	**2017 (ii)**	**2018**	**2019E**	**2020E**
Net asset value	73.4	69.7	69.0	70.7	75.9
NAV/share	171.2	162.5	160.9	165.0	177.1
Net Tangible Asset Value	2.4	2.5	2.3	1.9	2.6
NTAV/share	5.6	5.8	5.4	4.3	6.1
Average equity	74.4	80.6	78.1	72.3	70.0
Post-tax ROE (%)	10.5%	(1.7%)	5.0%	6.1%	7.2%

METRICS	**2016(i)**	**2017 (ii)**	**2018**	**2019E**	**2020E**
Revenue growth	6.9%	32.5%	(29.5%)	5.6%	0.0%
Adj EBITDA growth	17.0%	(80.7%)	228.5%	15.3%	10.0%
Adj EBIT growth	18.0%	(90.7%)	558.5%	10.6%	9.6%
Adj PBT growth	21.8%	(134.3%)	(231.9%)	33.7%	13.0%
Adj EPS growth	19.7%	(133.6%)	(188.6%)	34.1%	13.0%
Dividend growth	16.7%	(20.0%)	10.0%	7.1%	10.0%
Adj EBIT margins	10.7%	(1.4%)	5.6%	6.1%	6.8%

VALUATION	**2016(i)**	**2017 (ii)**	**2018**	**2019E**	**2020E**
EV/Sales (x)	1.1	0.8	1.2	1.1	1.1
EV/EBITDA (x)	7.8	40.2	12.3	10.6	9.7
EV/NOPAT (x)	12.7	(72.2)	25.6	22.4	19.8
PER (x)	9.7	N/A	32.5	24.3	21.5
Dividend yield	0.8%	0.6%	0.7%	0.7%	0.8%
FCF yield	(2.1%)	(3.3%)	3.5%	3.3%	3.5%

Source: Company information and Progressive Equity Research estimates. Note: (I) FY2016 is a June year end; (II) FY2017 is 17 months to November 2017

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