PROGRESSIVE EQUITY RESEARCH

12 March 2013

K3 BUSINESS TECHNOLOGY GROUP

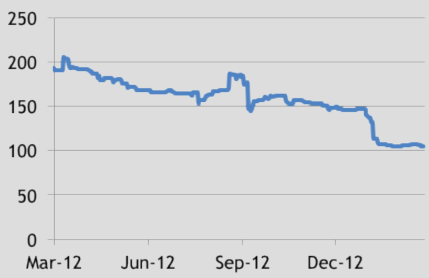
SOFTWARE & COMPUTER SERVICES

KBT.L

100p

Market Cap: £28.5m

SHARE PRICE PERFORMANCE



12m high/low	205/100

Source: LSE Data

KEY INFORMATION

Enterprise value	£44.2m
Index/market	FTSE AIM
Next news	July 2013
Gearing	55%
Interest cover	8.7x

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NO PAIN – NO GAIN

Summary

K3's results for H1 FY13 show the pressures that were well-heralded in the trading update on 21 January. The group has suffered from a downturn in the Retail marketplace, impacting the UK business and many of the International operations.

We continue to believe that K3 is doing the right things : investing in Retail AX and migrating to managed services. Unfortunately, both of these have led to short-term pressure, but we believe this is pain worth taking in return for the likely long-term gain. Although risk remains, there are many reasons to believe that H2 should deliver better news – we highlight these overleaf.

Impact on estimates and investment case

K3 has reported H1 revenues down 5% to £31.6m, and adjusted EBIT down by more than half to £2.9m, post the investment in Project Gemstone (Retail AX software IP) to the tune of £2.2m. Cash generation was very strong at £6.9m, compared to the prior year's £5.8m, highlighting strong working capital discipline, and the attractive cash profile of many of the revenue streams. We leave our full-year forecasts unaltered, and take comfort that, although much remains to be done in H2, there are a number of positive reasons to believe.

As we described in our note of 22 January 2013, "*High Street Blues*", we believe that K3 is doing the right thing, but that two aspects of its correct long-term strategy are causing short-term pain, namely :

- **Investment in MS Retail AX** The group aims to replicate its strong position in Retail NAV and Pebblestone. K3 expects to become Microsoft's "partner of choice" given its high level of investment and sector expertise, but clearly the short-term investment hurts the P&L, exacerbated by the difficult current trading environment across the retail sector in the UK and overseas

- **Migration to managed services** Outside of Retail AX, K3 is pushing hard towards multi-year managed services and hosting revenue. This relates to Sage and SYSPRO implementations in particular, where K3's major push is to win long-term relationships generating many years of recurring revenue at good margin. Necessarily, these contracts take time to win, and early financial returns are tempered by costs, both of selling and of setup

FORECASTS (JUNE)	2011	2012	2013E	2014E
Revenue	52.8	68.0	68.7	72.5
Adjusted EBITDA	10.6	12.9	9.6	11.9
Adjusted PBT	8.7	10.0	6.7	9.0
Adjusted EPS	22.8	24.4	16.4	21.8
EV/Sales	0.8x	0.7x	0.6x	0.6x
EV/ Adj. EBITDA	4.2x	3.4x	4.6x	3.7x
P/E	4.4x	4.1x	6.1x	4.6x

Source: Progressive Equity Research Limited forecasts

H1 results analysis

Divsional performance

	Revenue H1 FY13	Revenue H1 FY12	Adj EBITA H1 FY13	Adj EBITA H1 FY12
Microsoft UK	8.5	12.1	-1.3	1.5
International	5.4	4.8	0.5	1.4
SYSPRO/Sage	14.6	13.8	4.1	4.1
Managed Svcs	3.1	2.6	-0.2	0.1
Central			-0.2	-0.2
Total	**31.6**	**33.4**	**2.9**	**6.9**

Source: Company information

Microsoft UK : Revenue £8.5m (£12.1m); adj EBIT loss £1.3m (profit £1.5m)

This division has seen H1 results impacted dramatically by two factors : the ongoing and significant investment in K3's retail solution based on MS Dynamics AX ("Retail AX") under the Project Gemstone initiative, and the equally ongoing and significant downturn in retail customers' current propensity to spend on IT.

The group is hoping to become Microsoft's partner of choice for the Retail AX offering, and a strong global reseller platform is already in place to ensure rapid monetisation of investment once the products are launched, due in the group's Q4. Clearly there remains risk that either the product shipments are delayed, or that customers prove unwilling to sign licences in the anticipated timeframes, but we believe that investors should (and are beginning to) look beyond the short-term pressures and toward the long-term opportunity afforded by both the next-generation product and a potential market recovery. The sales pipeline is up from £29m to £36m, which bodes well on both fronts.

International : Revenue £5.4m (£4.8m); adj EBIT £0.5m (£1.4m)

The International business was able to increase revenues year-on-year due to the acquisition of Unisoft in December 2011, but profitability was lower for a number of reasons. Firstly, Unisoft was, as expected, loss-making. Secondly, the IKEA-related units saw strong revenues, but were unable to exceed the prior year's extremely buoyant figures. Thirdly, the Dutch fashion distribution market has seen subdued trading, with consequently depressed demand levels.

SYSPRO and Sage : Revenue £14.6m (£13.8m); adj EBIT £4.1m (£4.1m)

This unit, which sells to the manufacturing sector and more broadly ERP suites, has seen revenues grow on the back of acquisitions. It is clear that both Sage and, more particularly, SYSPRO have been remarkably resilient given the macro backdrop. The group is having success with X3 (a high-end Sage platform), although there was the inevitable slowdown in demand for alternatives (Sage 500 and 1000) in the runup to X3 availability. The SYSPRO team has sold seven deals for a total of £1.7m, compared to the prior year's six deals for £0.6m.

Managed Services : Rev £3.1m (£2.6m); adj EBIT loss £0.2m (profit £0.1m)

The managed services offering has seen steady expansion of customer numbers (398 from 346), and modest increase in recurring revenue (£2.1m from £2.0m) but has suffered from customer lethargy as it seems to require a major "event" to precipitate a customer's move to managed services; examples might be M&A or the introduction of a new software suite or hardware platform. Given the depressed economic conditions, such events have been fewer and further between than the group would have liked. The team is expanding the range of supported solutions within the managed services environment, and the delivery capability was enhanced significantly during H2 FY12.

Seasonality comment

K3 has traditionally seen a stronger H1 than H2 in terms of seasonal phasing of revenues and, more dramatically, profit. This was due to the SYSPRO renewals which tended to fall in K3's H1, boosting the performance of the entire group in this period each year.

Given that our forecasts (and consensus) call for adjusted PBT for the full year of c£7m, and that H1 has delivered c£3m, clearly there is a requirement for this historic trend to be reversed in order for the group to reach consensus estimates for FY13.

There are a number of factors which give us comfort that, although clearly risks remain, the full year estimates are achievable :

- **Retail licence sales expected to begin in K3's Q4** With availability of the Retail AX product scheduled in this timeframe, the group expects at least some customers to adopt the solution rapidly, and deliver revenues against the Project Gemstone investment. Given the group's standing in the retail software market, its existing strength in Microsoft NAV, and the support apparently forthcoming from Microsoft, we believe there are good reasons to believe that such sales could be significant.
- **Unisoft renewals due in H2** The Unisoft acquisition has delivered a significant level of recurring revenue, with a major block of renewals falling early in the calendar year, in K3's H2. This adds both cash and profit to the H2 period in a way that has not historically been the case.
- **Sage and IKEA enhancement revenues** Both Sage and IKEA have been performing well, and both businesses have good levels of revenues likely (or due) to fall within the group's H2. The Sage business, in particular, could benefit from the twin effect of X3 beginning to gain real traction, and a recently-reduced cost base which trims some £0.4m from the H2 overhead.
- **SYSPRO global hosting** The SYSPRO hosting deal is beginning to bear fruit, with a number of resellers in different geographies now actively promoting hosting to customers. K3 has a deal to host SYSPRO globally on behalf of SYSPRO itself, which should continue building momentum through H2 – the H1 results saw a positive impact from Scotiabank, and others are anticipated.

Essentially, H1 FY13 saw a number of headwinds across almost all areas of the business. With a modest abating of these headwinds, and steady delivery on initiatives already under way, we believe there are a number of ways in which the group can deliver H2 profitability ahead of H1, and therefore reach our forecast levels.

Valuation

The group trades at an EV/EBITDA of 4.6x 2013E figures. While this might seem an appropriate multiple for a "run-rate" profitability measure, it could be argued that current profitability is below "run-rate" levels, impacted as it is both the by investment in Retail AX, and by the macro environment. FY12 (and even FY11) represent perhaps more realistic earnings levels, to which we suspect the group could relatively easily return – indeed this is approximately what our FY14 forecasts suggest. On this basis, the group trades on an EV/EBITDA of around or even below 4x, which is perhaps what attracted the attentions of those who attempted to take the business private – any meaningful delivery on either the Retail AX or the managed services propositions could see earnings at dramatically higher levels.

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