EDISON

K3 Business Technology

Interim results

Adjusting to the cloud

Software & comp services

K3 reported H116 results in line with management expectations. Revenue growth was limited by currency and the shift to consumption-based licensing, but adjusted operating profit increased 25% y-o-y with margin expansion to 12.2%. Good progress has been made with the strategy to increase own-IP software sales, build out the reseller channel and grow the hosting business, although the impact of the shift to consumption-based licensing leads us to reduce our revenue and EPS estimates.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
06/14	72.0	6.6	18.5	1.25	18.9	0.4
06/15	83.4	7.2	19.1	1.50	18.3	0.4
06/16e	86.5	9.2	23.3	1.65	15.0	0.5
06/17e	89.9	10.3	25.6	1.82	13.6	0.5

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

Good progress made in H116

K3 reported H116 revenue growth of 1.5% (4% in constant currency. Adjusted operating margin expanded to 12.1% from 9.9% a year ago, as sales of own-IP products made up a larger percentage of revenues and the costs of implementing software were reduced. The weak euro had some impact at the revenue level, with less impact on profitability. K3's strategy to grow own-IP software sales and develop its partner channel to widen the addressable market for its software made progress in the period, with three major deals signed via the partner channel.

Shifting business model drives changes to forecasts

With the launch of cloud-based Microsoft Dynamics AX7 and the increasing popularity of consumption-based licensing models, where the user licenses the software on a subscription basis or pays for a perpetual licence over multiple years, K3's software revenues and cash receipts are likely to be lower than expected on a near-term basis. However, this should result in higher levels of recurring revenue and lifetime values in the longer term. We have reduced our FY16 and FY17 revenue forecasts by 2.6% and 4.2% respectively, leading to reductions in our normalised EPS forecasts of 1.5% in FY16 and 9.8% in FY17.

Valuation: Own-IP strategy to drive upside

The stock is trading on a P/E multiple of 15.0x FY16e EPS and 13.6x FY17e EPS compared to UK software and IT services stocks trading on an average 21x current year and 16x next year EPS. K3 continues to invest in developing and supporting its own-IP solutions and building out its partner channel. Combined with a focus on selling hosting services to a larger proportion of customers, the company has the potential to grow the business on a multi-year basis. We would expect upside triggers to include evidence of more "ax|is" contract wins, continued progress with the international partner channel, further debt reduction and the managed services business winning customers. We believe that the stock could trade up to at least 15x FY17e EPS (384p per share).

22 March 2016

Price	**349.5p**
Market cap	**£111m**

Net debt (£m) at end H116	10.45
Shares in issue	31.9m
Free float	78%
Code	KBT
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(0.7)	(4.3)	54.7
Rel (local)	(4.6)	(5.9)	72.5
52-week high/low		373.50p	225.00p

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

Trading update	July 2016

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Edison profile page

K3 Business Technology is a research client of Edison Investment Research Limited

Investment summary

Company description: ERP and business software specialist

K3 is a software developer and value-added channel partner; the company designs, resells and implements ERP and related business software solutions for the retail, distribution and manufacturing sectors. The group has a well-balanced business model of predictable, recurring licence income in the manufacturing software sector combined with higher growth opportunities in retail software, and offers managed services across all divisions. K3 is focused on developing its own software to enhance margins and create specialist solutions in target verticals.

Financials: Moderating forecasts for change in pricing model

K3 reported 1.5% revenue growth in H116, with the weaker euro having a negative impact. The company made good progress selling own-IP product and won several major contracts through its international partner channel. Gross margins improved year-on-year, as higher margin own-IP and hosting revenues made up a greater proportion of the total. In addition, measures to reduce the cost of implementation have started to have a positive impact. Adjusted operating profit increased 25% y-o-y, with margins expanding from 9.9% to 12.1%. Reflecting increasing customer demand for consumption-based pricing, which reduces short-term revenues and cash inflows, we have reduced our revenue, operating profit and EPS forecasts and increased our net debt forecasts for FY16 and FY17.

Exhibit 1: Changes to forecasts

	EPS			PBT			EBITDA		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
FY16e	23.7	23.3	(1.5)	9.3	9.2	(1.1)	13.5	13.4	(0.7)
FY17e	28.4	25.6	(9.8)	11.3	10.3	(8.9)	15.4	14.4	(6.5)

Source: Edison Investment Research

Valuation: Own-IP strategy to drive upside

The stock has undergone a significant re-rating, with a 53% gain in the share price over the last 12 months. The stock now trades on a P/E multiple of 15.0x FY16e EPS and 13.6x FY17e EPS compared to sub-£500m market cap UK software and IT services stocks trading on an average 21x current year and 16x next year EPS. K3 continues to invest in developing and supporting its own-IP solutions and building out its partner channel. Combined with a focus on selling hosting services to a larger proportion of customers, the company has the potential to grow the business on a multi-year basis. The company may also consider accelerating growth through acquisition, specifically to build out the product range. We would expect upside triggers to include evidence of more “ax│is” contract wins, continued progress with the international partner channel, further debt reduction, and the managed services business winning customers. We believe that the stock could trade up to at least 15x FY17e EPS (384p per share).

Sensitivities: Macro, organic growth, technology

The main sensitivities or risks to our forecasts are: 1) the macro environment; 2) organic growth, which depends on the ability to hire and retain skilled staff; 3) technology – the managed services business uses third-party data centres and could be negatively affected by service disruptions; 4) the timing and outcome of product development is uncertain; and 5) K3 is dependent on the technology roadmaps of the software vendors that it resells.

Company description: ERP and business software specialist

K3 is a software developer and value-added channel partner; the company designs, resells and implements ERP and related business software solutions for the retail, distribution and manufacturing sectors. The group has a well-balanced business model of predictable, recurring licence income in the manufacturing software sector combined with higher growth opportunities in retail software and offers managed services across all divisions. K3 is focused on developing its own software to enhance margins and create specialist solutions in target verticals.

Background

K3 started life in 2000 as the result of a buyout of the UK manufacturing Enterprise Resource Planning (ERP) business of Kewill Systems, comprising two business units and c 1,500 customers with a high proportion of recurring revenues. In 2001, K3 joined AIM through a reverse acquisition. Since then the company has broadened its offering with a series of acquisitions. These have expanded the company's ERP and business solution offerings in the manufacturing, retail and distribution sectors and added a managed services offering.

Software solutions business model: Grow internal IP

The group supplies ERP products based on Microsoft and Sage technology and business intelligence solutions from Microsoft and QlikView (see Exhibit 2).

Exhibit 2: Product range

Microsoft-based	Sage-based	Other
SYSPRO (based on .NET)	Sage ERP 1000	Unisoft POS
Dynamics NAV	Sage Line 500	QlikView (business intelligence)
Dynamics AX	Sage 200	
Dynamics CRM	Sage ERP X3	
Dynamics RMS	Sage CRM	
Business Intelligence	Sage SalesLogix	

Source: K3 Business Technology

Group strategy has been to focus on adding internal IP to the Microsoft-based product range. As a straight reseller of Microsoft products, K3 would achieve a gross margin of c 30-55% on software sold, depending on the product. By adding its own proprietary software to customise products for more specific requirements, K3 is able to retain a higher percentage of the software licence fee.

In H116, 25% of licence revenues was generated from own IP products (H115: 23%). Exhibit 3 shows how the development of proprietary IP is contributing to revenue and margin growth. K3 is organised into two divisions and reports financials on this basis. For each division, the table shows the value of software sold that is based on K3's IP and any related services, recurring revenue or hardware sales flowing directly from this licence sale. In H116, own-IP related revenues generated a gross margin of 65.6% compared to a group gross margin of 55.6%; excluding own-IP related revenues, remaining revenues generated a gross margin of 52.7% (up from 47.0% a year ago).

Product development: Core IP team plus potential for acquisitions

In H116, the company shifted product development staff out of their respective business areas to create one core IP development team. This should allow the team to share expertise, particularly as products are developed for Microsoft AX and NAV solutions in both divisions. It should also allow developers to focus on building strategic K3 solutions rather than being allocated to work on customer-specific contracts.

The company has also stated that it would consider making acquisitions to bolster its product range – we would expect this is more likely to be focused on the Retail division.

Exhibit 3: Revenues and gross margins generated from own-IP products

£m	H114	H214	H115	H215	H116	y-o-y	h-o-h
Product licence revenues	**4.11**	**3.99**	**4.54**	**4.1**	**4.89**	**7.7%**	**16.4%**
Retail	2.1	2.38	2.62	2.78	3.13	19.5%	8.7%
Manufacturing & distribution	2.01	1.61	1.92	1.32	1.76	-8.3%	33.3%
Product related revenues	**2.86**	**4.21**	**4.53**	**4.62**	**4.67**	**3.1%**	**1.1%**
Retail	2.57	4.2	4.32	4.08	4.49	3.9%	10.0%
Manufacturing & distribution	0.29	0.01	0.21	0.54	0.18	-14.3%	-66.7%
Gross profit	**4.59**	**5.56**	**5.8**	**5.92**	**6.27**	**8.1%**	**5.9%**
Retail	2.56	4.15	3.84	4.18	4.47	16.4%	6.9%
Manufacturing & distribution	2.03	1.41	1.96	1.74	1.8	-8.2%	3.4%
Gross margin	***65.9%***	***67.8%***	***63.9%***	***67.1%***	***65.6%***	***1.6%***	***-1.5%***
Retail	*54.8%*	*63.1%*	*55.3%*	*60.1%*	*58.7%*	*3.3%*	*-1.4%*
Manufacturing & distribution	*88.3%*	*87.0%*	*92.0%*	*93.5%*	*92.8%*	*0.8%*	*-0.8%*
K3 IP-related revenues/total revenues	**20.2%**	**21.9%**	**21.8%**	**21.1%**	**22.6%**	**0.8%**	**1.5%**
Non-IP related revenues	27.49	29.29	32.60	33.04	32.73	0.4%	-0.6%
Non-IP related gross profit	14.33	14.48	15.31	15.95	17.25	12.7%	8.2%
Non-IP related gross margin	*52.1%*	*49.4%*	*47.0%*	*48.3%*	*52.7%*	*5.7%*	*4.3%*

Source: K3 Business Technology Group

Expand product distribution channels

With the development of the ax│is fashion solution in the Retail division, the company started to develop its reseller channel to increase the addressable market outside of K3's traditional UK and Dutch markets. In the Retail division, K3 is working with a number of global system integrators to take its software into the rest of Europe and the US. In Manufacturing & Distribution, K3 is working in building out its SYSPRO reseller channel.

Managed services: Cross-sell and support globally

K3 has developed its managed services business through a combination of in-house development and acquisition. In addition to offering outsourced IT support to its customer base, K3 offers application hosting to its 3,000-strong customer base, with the ability to host all products sold including own-IP solutions. K3 is focused on selling managed services across its customer base; for example, all SYSPRO contracts are sent out with a hosting option. K3 has an agreement with SYSPRO to provide hosting services to the wider 15,000-strong global SYSPRO customer base, providing an additional source of hosting customers. In H116, managed services and hosting made up 13% of group revenues.

Rebranded as Starcom

Since buying Willow Starcom (a Wigan-based hosting and managed services business) in April 2015, the company has rebranded its entire hosting and managed services business as Starcom, and has integrated the three existing managed services business into one. While focused on growing the proportion of K3 customers using its hosting services, Starcom also provides hosting services to companies that are not K3 software customers.

Certified Microsoft CSP

K3 was recently certified by Microsoft as an Azure Tier 1 CSP (cloud service provider). This allows K3 to sell and manage Azure hosting services alongside its own hosting service.

Management

David Bolton stepped up to the CEO role in January 2014 from his role as CFO, having worked with the previous CEO since the formation of K3. Brian Davis moved into the CFO role at the same time;

he had been head of finance since 2007. The company's group operations director, Andrew Hodges, previously held commercial and operations director roles in K3's Microsoft UK division.

Retail division (47% of H116 revenues)

Building IP to enhance Microsoft Dynamics technology

This division develops and sells Microsoft Dynamics AX and Microsoft Dynamics NAV-based solutions for the retail market. Operations are based in the UK and Holland, with three satellite offices to support overseas customers. The core offering is based around K3's "ax│is" technology, which is based on and enhances Microsoft AX for Retail. K3 started developing the IP for this solution in FY13. In FY14, it released version one of the solution, named "ax│is fashion", and later that year won nine major contracts worth £12.6m for the solution. While the initial focus is on the fashion segment of the retail market (the second largest after food retail), the company expects to use the core "ax│is" technology to develop other retail vertical solutions such as for "big-ticket" items. In addition to the flagship AX-based solution, K3 previously developed a retail-specific solution based on Microsoft NAV, which is targeted at small and mid-sized retailers. The company also offers complementary products such as business information, channel and point-of-sale software. All products are available for hosted or on-premise delivery. In July 2015, K3 was awarded "Inner Circle" status by Microsoft – this is only awarded to less than 60 of Microsoft's fastest growing partners.

IKEA relationship provides recurring revenues

A longstanding customer for this division is Inter IKEA Systems, which signed an exclusive five-year agreement at the end of FY12 for K3 to support the IKEA Master Version software used by franchisees outside the IKEA group; this contract has since been extended until 2020 (including a multi-year enhancement licence). There are 14 franchises based in Europe, the Middle East, the Far East and Australia. Existing franchisees are encouraged to open up new stores in existing and new countries, and IKEA expects them to use K3's solution when they do so.

Recent contract wins confirm channel strategy progress

We believe that the ax│is fashion solution is one of only a few in the market that has been specifically developed for AX for Retail and therefore K3 has an opportunity now to exploit its head start on a global basis. While in the UK K3 typically sells direct and implements its own projects, in order to maximise potential sales outside of the UK, K3 is looking to build out its partner channel. The appeal for system integrators is that K3 provides vertical-specific software that is not available directly from Microsoft, and having access to this provides a competitive advantage when selling to global retailers. This is particularly attractive to Microsoft-focused system integrators such as Avanade, Microsoft's largest AX partner.

In September, the company announced it had signed an ax│is contract with TriStyle (a European mail order fashion retailer) in Germany via a global system integrator (GSI) – its largest contract to date through this channel and its first contract win in Germany. Since then, it has signed two more contracts via channel partners, one of which was with KLiNGEL, Germany's largest online retailer.

Current trading

For divisional performance data, refer to Exhibit 5 on page 9. The retail division received major orders worth £6.6m compared to £6.8m a year ago and added 51 new customers (H115: 33). The division saw total revenue growth of 0.5% y-o-y. Software licence revenues were up 10% y-o-y, service revenues were effectively flat, while recurring revenues were 9% lower (the division experienced a lower level of renewals, particularly for multi-year enhancement deals). With exposure to the euro via its Dutch business, revenues were negatively affected by the weaker euro versus sterling, although this had a smaller impact at the adjusted operating profit level. The company noted that it sold its first major cloud-based subscription contract for Microsoft Dynamics NAV in Q216.

Divisional gross margins expanded to 52.0% from 43.6% a year ago, helped by several factors. Higher-margin own IP-related revenues grew by 10% y-o-y to make up 39% of divisional revenues (H115: 35%). Services gross margins improved to 30.5% from 20.6% in H115 as measures taken by management to reduce the cost of implementation took effect. Operating expenses increased 3% y-o-y, resulting in an adjusted operating margin of 12.7%, up from 5.4% a year ago. The majority of H116 exceptional costs were incurred in this division resulting from the restructuring of divisional management and work to tackle performance issues in the Dutch business. Management estimates that the restructuring could lead to annualised cost savings of £1.4m.

Outlook

The retail division had a pipeline worth £26.3m at the end of H116 (H115: £28.7m), including for both ax│is and other more established solutions. Management noted that it is well advanced with initial work on a contract for a large global fashion retailer – this could result in significant multi-year revenues.

Impact of shift to consumption-based pricing

The company has noted that customers are shifting towards consumption-based pricing structures. This means that in addition to K3 selling perpetual licences with an upfront licence fee that is paid for and recognised when the contract is signed, customers are also signing up to use software on a subscription basis. In this case, companies pay one fee for the software licence, enhancements, support and hosting, driving up the level of recurring revenues. Management estimates that while this leads to lower revenues in the short term, it could lead to higher customer lifetime values than the perpetual licence model. The company is also signing contracts where the licence fee is paid for over a number of years. The impact on reported financials will be to reduce the cash received in the initial period when the contract is signed, but will result in cash receipts over multiple periods. Licence revenue recognition will depend on the terms of the licence, the delivery schedule and the credit status of the customer.

Microsoft has very recently launched Microsoft Dynamics AX7 – initially it will only be available hosted on Azure. K3's ax│is solution is already available for this and would also be hosted on Azure. In time, it is expected that Microsoft will launch an on-premise version of AX7.

Manufacturing and distribution (53% of H116 revenues)

This division supplies SYSPRO, Sage and Microsoft Dynamics AX and NAV solutions to c 1,000 manufacturing customers and c 700 distribution customers. As in the retail division, K3 develops its own IP to enhance the SYSPRO and Microsoft Dynamics functionality. Own-IP products include advanced planning and scheduling, warehouse management, pallet management, data integration and payroll/HR. The division offers hosting and managed services for all solutions and, as described on page 4, has launched a cloud service for SYSPRO.

K3 is SYSPRO's exclusive partner in the UK and Europe. SYSPRO is a Microsoft.NET-based ERP solution developed for the manufacturing sector. This business generates a high level of licence and support renewals in the second half of each calendar year (ie K3's H1). The business has recently updated some of its own IP SYSPRO products, including Dataswitch Connectivity, Equator Payroll and Orchard Warehouse Management.

K3 is one of Sage's largest partners in the UK, and is the largest reseller of Sage X3. Sage X3 is Sage's most advanced ERP offering and is targeted at mid-market companies.

All hosting and managed services results are reported in this division, although we note that a proportion of revenues are generated from Retail customers.

Current trading

Divisional revenues were up 2.4% y-o-y (see Exhibit 5 on page 9). Taking into account the £1.5m of revenues contributed by the Starcom acquisition, revenues declined 4.4% y-o-y. New orders worth £4.7m were received in the period (H115: £5.5m) – management noted that several large software deals shifted into H216 – and 60 new customers added (H115: 48). The SYSPRO business performed in line with management expectations, maintaining the renewal rate at 98% and making its first sales through channel partners. The Sage business saw lower licensing and related service revenues, although the company has seen a pick-up in demand since the period end. The Dynamics NAV and AX business was weaker than expected, but closed the period with a strong pipeline, which has since started to convert. Hosting and managed services contributed recurring revenues of £3.79m (28% of divisional recurring revenues and up 39% y-o-y) and at the end of H116 had an £8.22m contracted run rate of subscription income, up 29% y-o-y and 3% h-o-h.

The divisional gross margin increased from 56.9% in H115 to 58.8% in H116 – each revenue stream increased margins, through a combination of better efficiency in delivery and a higher proportion of hosting services. Operating expenses increased by 12% y-o-y as Willow Starcom was integrated into the business and the full impact of additional heads hired in H215 took effect.

Outlook

The division had a pipeline worth £30.2m at the end of H116 (H115: £28.0m). Management is focused on growing the cloud hosting business.

Sensitivities

The main factors influencing our forecasts and the share price are:

- **Macro environment:** consumer spending has an impact on retail and manufacturing demand.
- **Organic growth:** in all divisions, organic growth depends on the ability to hire and retain skilled staff. This is particularly evident in the Microsoft AX business, where the company has hired and is training AX resources to meet customer demand for the new "ax|is" solution.
- **Technology:** the managed services business relies on third-party data centres – any breach in security or service disruption could influence customer demand. The outcome in terms of timing and uptake of new product development is uncertain.
- **Dependence on software vendors:** as a value-added reseller, K3 sells and develops software solutions based around third-party software (Microsoft, SYSPRO, Sage). The company is therefore dependent on the technology roadmaps of these third-party vendors.

Financials

Review of H116 results

Exhibit 4: H116 results highlights

£000s	H116	H115	Change
Revenues	42,291	41,669	1.5%
Normalised* operating profit	5,111	4,117	24.1%
Normalised* operating margin	12.1%	9.9%	2.2%
Reported operating profit	2,665	2,344	13.7%
Normalised* profit before tax	4,724	3,566	32.5%
Normalised* net income	3,829	2,638	45.1%
Reported net income	1,872	1,219	53.6%
Reported EPS (p)	5.9	3.9	51.3%
Normalised* EPS (p)	11.9	8.2	44.6%
Net debt	10,453	12,074	-13.4%

Source: K3 Business Technology Group. Note: *Normalised profit measures exclude amortisation of acquired intangibles, exceptional items and share-based payments.

Group revenues grew 1.5% y-o-y; normalising for the effect of the weaker euro, constant currency growth reached 4% y-o-y. Recurring revenues made up 47% of the total, similar to a year ago. Gross margin improved from 50.7% a year ago to 55.6%, with margin improvements from the success of the company's programme to reduce implementation resourcing costs, the higher proportion of own-IP business, and the increased contribution from hosting and managed services (as the Starcom acquisition was integrated). Operating expenses increased 8.3%, with a large proportion of the increase accounted for by the integration of Starcom. Overall, this resulted in a 24% increase in normalised operating profit (as in Exhibit 4), with the margin increasing from 9.9% to 12.1% year-on-year. On a constant currency basis, normalised operating profit increased 36% to £4.84m. The effective tax rate of 19% was in line with our expectations, resulting in normalised EPS growth of 44.6% y-o-y.

Reducing net debt

Net debt reduced from £12.1m at the end of both H115 and FY15 to £10.5m at the end of H116. The largest element of debt is a secured loan repayable in August 2017 (at a rate of Libor +2.95%), of which £11.9m is outstanding. The company also has access to a £7.5m revolving credit facility, which is currently unused.

Exhibit 5: Divisional revenues and profits, H115-H116

£m	H115	H215	H116	y-o-y	h-o-h
Revenues					
Software	7.62	6.22	6.89	-9.6%	10.8%
Retail	4.08	3.06	4.5	10.3%	47.1%
Manufacturing & distribution	3.54	3.16	2.39	-32.5%	-24.4%
Services	11.93	12.92	13.18	10.5%	2.0%
Retail	7.63	7.48	7.68	0.7%	2.7%
Manufacturing & distribution	4.30	5.44	5.5	27.9%	1.1%
Recurring revenues	19.84	20.00	19.7	-0.6%	-1.4%
Retail	6.78	7.97	6.2	-8.6%	-22.2%
Manufacturing & distribution	13.06	12.03	13.5	3.5%	12.4%
Hardware & other revenues	2.28	2.62	2.5	9.6%	-4.6%
Retail	1.14	1.60	1.34	17.5%	-16.3%
Manufacturing & distribution	1.14	1.02	1.16	1.8%	13.7%
Total revenues	**41.67**	**41.76**	**42.29**	**1.5%**	**1.3%**
Retail	19.63	20.11	19.72	0.5%	-1.9%
Manufacturing & distribution	22.04	21.65	22.57	2.4%	4.2%
Gross profit	**21.11**	**21.87**	**23.52**	**11.4%**	**7.5%**
Retail	8.56	10.39	10.26	19.9%	-1.3%
Manufacturing & distribution	12.55	11.48	13.26	5.7%	15.5%
Gross margin	***50.7%***	***52.4%***	***55.6%***	***5.0%***	***3.2%***
Retail	*43.6%*	*48.0%*	*52.0%*	*8.4%*	*4.0%*
Manufacturing & distribution	*56.9%*	*58.0%*	*58.8%*	*1.8%*	*0.8%*
Adjusted* operating profit	**4.11**	**4.04**	**5.13**	**24.8%**	**26.9%**
Retail	1.06	2.45	2.51	136.8%	2.4%
Manufacturing & distribution	3.4	1.72	2.99	-12.1%	73.8%
Head office	-0.35	-0.13	-0.37	5.7%	186.8%
Adjusted operating margin	***9.9%***	***9.7%***	***12.1%***	***2.3%***	***2.5%***
Retail	*5.4%*	*12.2%*	*12.7%*	*7.3%*	*0.5%*
Manufacturing & distribution	*15.4%*	*7.9%*	*13.2%*	*-2.2%*	*5.3%*

Source: K3 Business Technology Group. Note: *Adjusted operating profit excludes amortisation of acquired intangibles and exceptional items.

Changes to forecasts

Exhibit 6: Changes to forecasts

£m	Old FY16e	New FY16e	Change	Old FY17e	New FY17e	Change	Growth FY16e	Growth FY17e
Retail	41.9	41.3	-1.3%	45.0	42.7	-5.1%	4.0%	3.3%
Manufacturing & distribution	47.0	45.2	-3.8%	48.8	47.2	-3.3%	3.5%	4.4%
Revenues	**88.85**	**86.54**	**-2.6%**	**93.80**	**89.90**	**-4.2%**	**3.7%**	**3.9%**
							Margin	
Retail	3.98	5.08	27.5%	5.26	5.21	-1.1%	12.3%	12.2%
Manufacturing & distribution	6.70	5.50	-17.9%	7.33	6.29	-14.1%	12.2%	13.3%
Head office costs	(0.54)	(0.54)	0.0%	(0.67)	(0.58)	-13.4%		
Normalised operating profit	**10.14**	**10.04**	**-1.0%**	**11.92**	**10.92**	**-8.4%**		
Normalised operating margin	***11.4%***	***11.6%***	***0.2%***	***12.7%***	***12.1%***	***-0.6%***		
Normalised PBT	9,339	9,239	-1.1%	11,321	10,317	-8.9%		
Normalised net income	7,653	7,564	-1.2%	9,186	8,323	-9.4%		
Reported EPS (p)	15.0	13.7	-8.5%	21.4	18.6	-13.1%		
Normalised EPS (p)	**23.7**	**23.3**	**-1.5%**	**28.4**	**25.6**	**-9.8%**		
Net debt	9,590	10,049	4.8%	4,558	7,031	54.3%		

Source: Edison Investment Research

We have revised our forecasts to reflect the weaker euro as well as the effect of increased demand from customers for consumption licensing. This results in a reduction in our revenue forecasts of 2.6% in FY16 and 4.2% in FY17. Reflecting the gross margins achieved in H116, we have raised our gross margin assumptions for both years, particularly in Retail. This results in a 1.0% cut to our adjusted operating profit forecast in FY16 and an 8.4% cut in FY17, and reduces normalised EPS by 1.5% in FY16 and 9.8% in FY17. We have increased our capex forecasts by £420k in FY16 and

£320k in FY17 to take account of slightly higher investment in product development and hosting assets. Combined with lower profitability and the shift towards consumption-based licensing (which has an impact on working capital) we have increase our net debt forecast in both years although we continue to forecast a reduction in the absolute amount each year.

Valuation

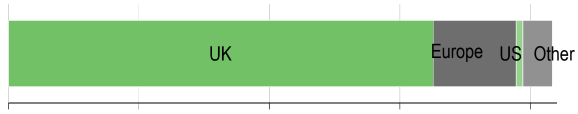
K3's share price has gained 53% over the last 12 months, as the company has shown good progress selling its new ax│is solution, developing its partner channel, improving profitability and reducing debt. The stock now trades on a P/E multiple of 15.0x FY16e EPS and 13.6x FY17e EPS. Sub-£500m market cap UK software stocks are trading on 22.3x current year and 17.3x next year EPS and UK IT service companies are trading on 18.6x current year and 15.3x next year EPS. K3 continues to invest in developing and supporting its own-IP solutions and building out its partner channel. Combined with a focus on selling hosting services to a larger proportion of customers, the company has the potential to grow the business on a multi-year basis. The company may also consider accelerating growth through acquisition, specifically to build out the product range.

We would expect triggers for further upside in the stock to include evidence of more "ax│is" contract wins, continued progress with the international partner channel, further debt reduction, and the managed services business winning customers. We believe that the stock could trade up to at least 15x FY17e EPS (384p per share), equivalent to an EV/sales multiple of 1.5x FY17e. K3 pays a small dividend, equivalent to a forecast yield of 0.5%.

Exhibit 7: Financial summary

£000s	2012	2013	2014	2015	2016e	2017e
Year end 30 June	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue	67,961	63,513	71,950	83,427	86,540	89,900
Cost of Sales	(28,491)	(30,375)	(32,990)	(40,446)	(39,742)	(41,603)
Gross Profit	39,470	33,138	38,960	42,981	46,799	48,297
EBITDA	12,942	7,261	9,861	10,975	13,364	14,442
Operating Profit (before am of acq. Intang. and except.)	11,405	5,164	7,328	8,169	10,039	10,917
Amortisation of acquired intangibles	(3,586)	(3,182)	(2,989)	(2,800)	(2,900)	(2,900)
Share-based payments	(72)	(70)	(27)	(18)	(30)	(30)
Other	(395)	(727)	(1,722)	(546)	(900)	0
Operating Profit	7,352	1,185	2,590	4,805	6,209	7,987
Net Interest	(1,309)	(723)	(705)	(926)	(800)	(600)
Profit Before Tax (norm)	10,096	4,441	6,623	7,243	9,239	10,317
Profit Before Tax (FRS 3)	6,043	462	1,885	3,879	5,409	7,387
Tax	(319)	780	675	(436)	(1,035)	(1,444)
Profit After Tax (norm)	8,591	4,165	5,874	6,162	7,564	8,323
Profit After Tax (FRS 3)	5,724	1,242	2,560	3,443	4,374	5,943
Average Number of Shares Outstanding (m)	28.2	29.2	31.4	31.6	31.9	31.9
EPS - normalised (p)	30.4	14.3	18.7	19.5	23.7	26.1
EPS - normalised fully diluted (p)	29.7	14.1	18.5	19.1	23.3	25.6
EPS - FRS 3 (p)	20.3	4.3	8.1	10.9	13.7	18.6
Dividend per share (p)	1.00	1.00	1.25	1.50	1.65	1.82
Gross Margin (%)	58.1	52.2	54.1	51.5	54.1	53.7
EBITDA Margin (%)	19.0	11.4	13.7	13.2	15.4	16.1
Operating Margin (before GW and except.) (%)	16.8	8.1	10.2	9.8	11.6	12.1
BALANCE SHEET						
Fixed Assets	68,325	69,398	67,067	67,497	65,972	64,147
Intangible Assets	21,255	21,040	20,040	20,806	19,356	17,706
Tangible Assets	2,722	2,927	2,439	2,316	2,241	2,066
Goodwill	43,540	44,610	43,952	43,541	43,541	43,541
Other	808	821	636	834	834	834
Current Assets	32,418	25,523	29,535	33,734	35,830	38,657
Stocks	0	0	0	0	0	0
Debtors	30,322	25,251	28,888	31,839	33,905	35,714
Cash	2,096	272	647	1,895	1,925	2,943
Current Liabilities	(48,043)	(39,272)	(40,278)	(32,886)	(32,170)	(36,276)
Creditors	(8,797)	(5,842)	(7,218)	(7,640)	(7,924)	(8,230)
Other Creditors	(21,468)	(19,379)	(18,799)	(21,803)	(20,803)	(18,603)
Short term borrowings	(17,778)	(14,051)	(14,261)	(3,443)	(3,443)	(9,443)
Long Term Liabilities	(5,797)	(4,524)	(3,719)	(14,850)	(12,210)	(3,660)
Long term borrowings	0	(32)	(14)	(10,531)	(8,531)	(531)
Other long term liabilities	(5,797)	(4,492)	(3,705)	(4,319)	(3,679)	(3,129)
Net Assets	46,903	51,125	52,605	53,495	57,422	62,868
CASH FLOW						
Operating Cash Flow	7,284	8,022	5,352	9,600	9,681	10,739
Net Interest	(839)	(820)	(848)	(950)	(800)	(600)
Tax	(1,312)	(1,217)	290	(264)	(1,675)	(1,994)
Capex	(3,160)	(4,613)	(4,487)	(4,564)	(4,700)	(4,600)
Acquisitions/disposals	(7,132)	(1,917)	(129)	(1,998)	0	0
Financing	5,026	2,677	277	69	0	0
Dividends	(214)	(286)	(316)	(397)	(477)	(527)
Net Cash Flow	(347)	1,846	139	1,496	2,030	3,018
Opening net debt/(cash)	15,486	15,682	13,811	13,628	12,079	10,049
HP finance leases initiated	0	0	0	0	0	0
Other	151	25	44	53	0	0
Closing net debt/(cash)	15,682	13,811	13,628	12,079	10,049	7,031

Source: K3 Business Technology Group, Edison Investment Research

Contact details	Revenue by geography
Baltimore House, 50 Kansas Avenue, Manchester M50 2GL +44 (0)161 876 4498 www.k3btg.com	

Management team

CEO: David Bolton

David qualified as a chartered accountant with Ernst & Young in the mid-1970s. He has held finance positions with both quoted and unquoted companies, most notably BTR, where he spent 12 years. He held the role of CFO from 1998 before moving into the CEO role in January 2014.

CFO: Brian Davis

Brian joined K3 in 2007 as group head of finance and was appointed to the CFO role in January 2014. Before K3, he worked at several listed companies in financial and commercial roles (including as group financial controller and company secretary at Spring Group) and before that spent 10 years at Arthur Andersen. He is an FCA.

Chairman: Lars-Olof Norell

Lars-Olof was appointed to the role of interim chairman in November 2014. He has extensive experience of the technology sector, having spent close to 30 years working at Capgemini. He continues to advise companies on their growth strategies and technology solutions.

Principal shareholders	(%)
PJ Claesson	18.7
Hargreave Hale	12.8
Kestrel Partners LLP	12.2
Investec Asset Management	5.6
Miton Asset Management	5.0
Herald Investment Management	4.4
David Bolton	3.0

Companies named in this report

Microsoft (MSFT:US), Sage (SGE:LN)

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60325 Frankfurt	London, WC1V 7EE	10167, New York	88 Phillip St, Sydney	Wellington 6011
Germany	United Kingdom	US	NSW 2000, Australia	New Zealand