

K3 Business Technology

Interim results

Shifting from product to customer focus

As previously flagged, delays in closing contracts in H117 hit profitability. Management launched a reorganisation programme to streamline the business and support cross-selling as well reduce the cost base. Better software sales in H217 combined with the reduction in overheads should result in a recovery in profitability in H217 and FY18. K3 continues to focus on selling own IP-based products and hosting services to new customers as well as its 3,700-strong customer base. We leave our forecasts largely unchanged.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
06/15	83.4	7.2	19.1	1.50	13.4	0.6
06/16	89.2	8.8	23.0	1.75	11.1	0.7
06/17e	92.6	7.3	15.8	1.93	16.1	0.8
06/18e	94.0	10.5	22.9	2.12	11.1	0.8

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

Deal slippage hits H117 profitability

As highlighted by the company in January, deal slippage in both the Retail and Manufacturing & Distribution businesses resulted in lower than expected revenues in H117. The shortfall in high-margin license revenues combined with investment in the partner channel resulted in a drop in adjusted operating profit to £0.45m from £5.11m in H116. Management is confident that deals have been delayed rather than gone away, and the increase in the pipeline (£82m at end H117 vs £76m at the end of FY16) bears this out. Contracts signed post period-end show that the pipeline is starting to convert and support sequential revenue growth in H217.

Reorganisation well underway

The new management team launched a reorganisation of the business mid-way through H117. This is designed to streamline the business in order to make it easier to cross-sell own-IP and third-party products across the company's 3,700-strong customer base as well as offer comprehensive solutions rather than single products to new customers. This should result in annualised cost savings of c £3m. Our normalised operating profit forecasts are substantially unchanged. Factoring in higher interest expenses, we reduce our normalised EPS forecast by 5% in FY17 and 6% in FY18. We forecast a reduction in net debt from the £12.5m reported at end H117 to £10.2m by the end of FY17 and £5.5m by the end of FY18.

Valuation: Attractive on FY18 forecasts

K3 is trading on 16.1x FY17e normalised EPS and 11.1x FY18e compared to small-cap UK software and IT services stocks trading on an average 17.5x current year and 16.6x next year EPS. Based on our FY18 forecasts, K3's valuation looks attractive. Evidence of pipeline conversion and successful cross-selling from the reorganisation should provide support to our forecasts, which factor in a return to revenue growth in H217, in turn driving margin expansion in H217 and FY18. The increasing proportion of cloud-based deals, while reducing upfront revenue recognition, will help the company build a higher level of recurring revenues.

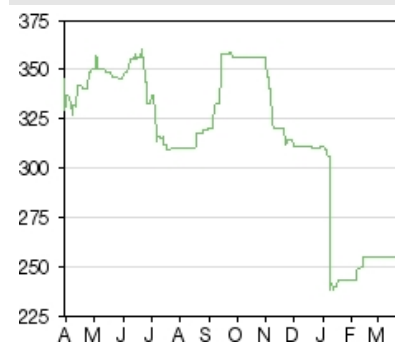
Software & comp services

28 March 2017

Price 255.00p
Market cap £92m

Net debt (£m) at end H117	12.5
Shares in issue	36.0m
Free float	80%
Code	KBT
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	0.0	(17.7)	(26.4)
Rel (local)	(1.4)	(21.1)	(38.2)
52-week high/low	360.0p		238.0p

Business description

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

Next events

Trading update	July 2017
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Review of H117 results

Exhibit 1: Half-yearly results			
£000s	H116	H117	Change
Revenues	42,291	42,974	1.6%
Normalised operating profit	5,111	469	-90.8%
Normalised operating margin	12.1%	1.1%	-11.0%
Reported operating profit	2,665	(3,825)	-243.5%
Normalised profit before tax	4,724	52	-98.9%
Normalised net income	3,829	(108)	-102.8%
Reported net income	1,872	(3,429)	-283.2%
Reported EPS (p)	5.9	(9.6)	-262.7%
Normalised EPS (p)	11.9	(0.3)	-102.5%
Net debt	10,453	12,511	19.7%

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

K3 reported a 1.6% revenue increase year-on-year. Excluding the impact of the Merac and DdD acquisitions (July 2016 and April 2016, respectively), revenues declined 7% y-o-y. Recurring revenues grew 7.6% to make up 49.4% of total revenues, up from 46.6% for H116 and 46.7% for FY16. A shortfall in software sales in both divisions combined with the higher cost base from the acquisitions resulted in normalised operating profit falling 91% y-o-y to £0.5m. The company incurred exceptional costs of £2.7m related to restructuring in H117. Net debt increased to £12.5m from £8.9m at the end of FY16.

Business update

Restructuring well underway

With the new management team joining in H117 (CEO Adalsteinn Valdimarsson and CFO Rob Price taking on their roles in October 2016), a major reorganisation programme was launched. This aims to streamline the business in order to improve the level of cross-selling. Products that have typically only been sold in the division in which they were originally developed are now being marketed more widely across the group. Examples include the Orchard Warehouse Management software and Dataswitch, which typically were only sold to SYSPRO customers but are now being sold through K3's global channel partners. The exceptional restructuring cost incurred in H117 totalled £2.74m and we forecast a total of £3m for FY17, as management believes it has completed the vast majority of the programme. This should result in annualised cost savings of at least £3m.

The website has been revamped and the group's products and services have been grouped into the following divisions:

- K3 B2B – focused on manufacturing and distribution businesses. Products include: Microsoft Dynamics NAV, AX, and 365; SYSPRO, Sage, and Microsoft Dynamics CRM.
- K3 B2C – retail focused. This includes k3 Retail, Merac, DdD (retail-in-a-box), k3 Retail Store Services (hardware rollouts), and Microsoft Dynamics CRM.
- K3 global accounts – eg IKEA.
- K3 managed services. This incorporates the Starcom business.
- K3 software solutions. This comprises products developed by K3, including Advanced Planning & Scheduling, ax|is, DataSwitch, DdD Retail, Fresh Dynamics, Orchard (WMS), K3 for Retail, pebblestone|fashion, and REALIZE.

The company continues to report financial performance across two divisions – Retail and Manufacturing & Distribution – and includes managed services within the Manufacturing & Distribution division.

Exhibit 2: Divisional performance					
£m	H116	H216	H117	y-o-y	h-o-h
Revenues					
Software	6.89	9.34	4.41	-36.0%	-52.8%
Retail	4.50	5.84	2.51	-44.2%	-57.0%
Manufacturing & distribution	2.39	3.50	1.90	-20.5%	-45.7%
Services	13.18	12.56	14.01	6.3%	11.5%
Retail	7.68	6.84	8.12	5.7%	18.7%
Manufacturing & distribution	5.50	5.72	5.89	7.1%	3.0%
Recurring revenues	19.72	21.90	21.21	7.6%	-3.2%
Retail	6.20	10.54	7.66	23.5%	-27.3%
Manufacturing & distribution	13.52	11.36	13.55	0.2%	19.3%
Hardware & other revenues	2.50	3.09	3.34	33.6%	8.1%
Retail	1.34	1.98	2.65	97.8%	33.8%
Manufacturing & distribution	1.16	1.11	0.69	-40.5%	-37.8%
Total revenues	42.29	46.9	43.0	1.6%	-8.4%
Retail	19.72	25.20	20.94	6.2%	-16.9%
Manufacturing & distribution	22.57	21.69	22.03	-2.4%	1.6%
Gross profit	23.52	25.02	22.48	-4.4%	-10.2%
Retail	10.26	13.10	10.48	2.1%	-20.0%
Manufacturing & distribution	13.26	11.92	12.00	-9.5%	0.7%
Gross margin	55.6%	53.4%	52.3%	-3.3%	-1.0%
Retail	52.0%	52.0%	50.0%	-2.0%	-1.9%
Manufacturing & distribution	58.8%	55.0%	54.5%	-4.3%	-0.5%
Adjusted* operating profit	5.13	4.37	0.45	-91.2%	-89.7%
Retail	2.51	3.54	(0.79)	-131.5%	-122.3%
Manufacturing & distribution	2.99	1.29	1.88	-37.1%	45.7%
Head office	(0.37)	(0.46)	(0.64)	73.0%	39.1%
Adjusted operating margin	12.1%	9.3%	1.0%	-11.1%	-8.3%
Retail	12.7%	14.0%	-3.8%	-16.5%	-17.8%
Manufacturing & distribution	13.2%	5.9%	8.5%	-4.7%	2.6%

Source: K3 Business Technology Group. Note: *Excludes amortisation of acquired intangibles and exceptional items.

Retail: Profitability down due to deal slippage

Overall revenues grew 6.2% y-o-y; excluding the £3.7m contributed by DdD and Mercac, revenues declined 12.6% y-o-y. Although the company continued to see good demand for its solutions, the sales cycle has lengthened; management believes that the shift to the cloud is extending the decision-making process for the customer. Consequently the division saw fewer major new software contracts in December than expected. Those deals are still in the pipeline, and one major deal has just been signed: the British Heart Foundation last week signed a contract for on-premise Dynamics AX software for 700 retail outlets; the contract is initially worth at least £2m. Services revenues grew 5.7% y-o-y and 18.7% h-o-h – contracts signed in June 2016 with Selco, Fortnum & Mason and Ann Summers were in implementation phase in H117 (although the use of external contractors weighted on the services gross margin, which fell to 23.9% from 30.5% a year ago). Recurring revenues increased 23.5% y-o-y helped by the addition of Merac and DdD, although revenues were down 27% h-o-h. Own IP product sales fell 26% y-o-y but own IP product-related sales grew 89% y-o-y. Overall, this boosted gross margins for software sales.

In Q217, the division signed the company's largest ever hosting deal linked to a Dynamics AX contract, when it signed up Fortnum & Mason (which had signed a software contract in Q416). The IKEA franchisee business remained strong and the company is looking to sell other K3 software solutions to the franchisees' non-IKEA businesses. The DdD and Merac acquisitions are performing well. DdD's "born in the cloud" technology is to be a core part of K3's "Next Generation" platform.

Weaker software sales and higher use of external resources resulted in a lower divisional gross margin year-on-year and half-on-half. Higher operating expenses due to increased investment in the partner channel and the IKEA relationship as well as adding in the overheads from the DdD and Merac acquisitions resulted in a drop in adjusted operating profit to -£0.79m from £2.51m a year ago.

Manufacturing & Distribution: First cloud AX deal signed

Divisional revenues declined 2.4% y-o-y. As for the Retail division, the business saw deal slippage. Recurring revenues increased marginally year-on-year, the majority of which comprises the support and maintenance renewals for the SYSPRO business, which are billed in October. The renewal rate remained at 98%. Services revenues grew 7.1% y-o-y as various projects were implemented over the period. The business sold its first Microsoft Dynamics 365 for Operations contract (previously known as AX7) – this is Microsoft's first cloud-based ERP solution. Starcom, the hosting and managed services business, saw a revenue decline of 5.5% to £5.11m, of which £3.95m is reported in recurring revenues (+4% y-o-y). As we have previously written, the business was affected by the loss of the MyLocal contract after the company went into administration. In September, the company noted that Sage sales had been weaker; the business is now starting to see a pick-up in new business.

As for the Retail division, lower software sales and increased use of external resources for implementation resulted in a lower gross margin versus H116 and H216. Lower operating costs offset some of this, resulting in adjusted operating profit of £1.88m, down from £2.99m a year ago.

Outlook and changes to forecasts

While longer sales cycles had a negative impact on performance in H117, management is confident that deals have not gone away, as evidenced by strong pipelines in both divisions. The Retail pipeline is up 80% y-o-y and 5% h-o-h to £47m. The Manufacturing & Distribution pipeline is up 17% y-o-y and 12% h-o-h to £35m. Since the end of H117, as well as the British Heart Foundation AX deal, the company has closed NAV, Sage and SYSPRO deals that were in discussion prior to the period end.

Management is considering changing the financial year-end to move away from the June and December period ends. With a June year-end, Microsoft offers discounting at period ends, which puts a very heavy weighting to contract signings in June and December. This makes forecasting difficult for management – shifting to a year-end such as November would put the peak signing months into the beginning of a period, rather than the end, and therefore give the company better visibility and reduce the potential for customers to use financial reporting as a tool to get better pricing.

In October 2016, the company refinanced the term loan that was due for repayment in August 2017 with a three-year revolving facility.

We have revised our forecasts to take account of the following:

- **Revenues:** we assume a significant pick up in software licensing in H217 across both divisions, as some of the delayed deals from H117 start to close. We raise our FY17 revenue forecast by 4.0% and FY18 by 4.2%, mainly due to higher than expect services revenues.
- **Gross margin:** we have increased our gross margin assumption for FY17 to reflect a recovery in software sales in H217.
- **Normalised operating profit:** higher gross profit in both years is offset by higher operating expense assumptions, to leave our normalised operating profit substantially unchanged. We have taken account of the cost savings expected from the reorganisation, but we have also

factored in a higher spend in H117 on the partner channel and the IKEA relationship than we had originally expected.

- **Interest charges:** based on the run rate in H117, we have increased our net finance cost assumptions for FY17 and FY18.
- **Normalised EPS:** overall, we reduce our normalised EPS forecast by 5.1% in FY17 and 5.9% in FY18, with the main difference relating to the higher interest expense.

Exhibit 3: Changes to forecasts

£m	Old	New	Change	Old	New	Change	Growth	
	FY17e	FY17e		FY18e	FY18e		FY17e	FY18e
Retail	45.50	47.54	4.5%	46.04	48.04	4.3%	5.8%	1.1%
Manufacturing & distribution	43.55	45.03	3.4%	44.20	46.00	4.1%	1.7%	2.2%
Revenues	89.05	92.57	4.0%	90.24	94.04	4.2%	3.8%	1.6%
							Margins	
Retail	5.39	4.31	-20.2%	6.91	5.82	-15.7%	9.1%	12.1%
Manufacturing & distribution	3.61	4.85	34.1%	5.28	6.39	21.0%	10.8%	13.9%
Head office costs	(0.89)	(1.07)	20.2%	(0.93)	(0.97)	4.3%		
Normalised operating profit	8.12	8.08	-0.5%	11.26	11.24	-0.2%		
Operating margin	9.1%	8.7%	-0.4%	12.5%	12.0%	-0.5%		
Normalised PBT	7.72	7.28	-5.7%	11.01	10.54	-4.2%		
Normalised net income	6.13	5.82	-5.1%	8.97	8.45	-5.9%		
Reported EPS (p)	2.3	1.2	-46.5%	18.2	17.1	-6.1%		
Normalised EPS (p)	16.7	15.8	-5.1%	24.4	22.9	-5.9%		
Net debt	10.02	10.17	1.5%	5.03	5.54	10.2%		

Source: Edison Investment Research

Exhibit 4: Financial summary

	£000s	2012	2013	2014	2015	2016	2017e	2018e
Year end 30 June		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS								
Revenue		67,961	63,513	71,950	83,427	89,175	92,570	94,040
Cost of Sales		(28,491)	(30,375)	(32,990)	(40,446)	(40,636)	(42,030)	(42,832)
Gross Profit		39,470	33,138	38,960	42,981	48,539	50,540	51,209
EBITDA		12,942	7,261	9,861	10,975	12,843	12,280	15,839
Operating Profit (before am of acq. intang. and except.)		11,405	5,164	7,328	8,169	9,529	8,080	11,239
Amortisation of acquired intangibles		(3,586)	(3,182)	(2,989)	(2,800)	(2,734)	(2,900)	(2,900)
Share-based payments		(72)	(70)	(27)	(18)	(28)	(30)	(30)
Other		(395)	(727)	(1,722)	(546)	(1,538)	(3,000)	0
Operating Profit		7,352	1,185	2,590	4,805	5,229	2,150	8,309
Net Interest		(1,309)	(723)	(705)	(926)	(701)	(800)	(700)
Profit Before Tax (norm)		10,096	4,441	6,623	7,243	8,828	7,280	10,539
Profit Before Tax (FRS 3)		6,043	462	1,885	3,879	4,528	1,350	7,609
Tax		(319)	780	675	(436)	(425)	(910)	(1,444)
Profit After Tax (norm)		8,591	4,165	5,874	6,162	7,650	5,820	8,445
Profit After Tax (FRS 3)		5,724	1,242	2,560	3,443	4,103	440	6,165
Average Number of Shares Outstanding (m)		28.2	29.2	31.4	31.6	32.4	36.0	36.0
EPS - normalised (p)		30.4	14.3	18.7	19.5	23.6	16.2	23.5
EPS - normalised fully diluted (p)		29.7	14.1	18.5	19.1	23.0	15.8	22.9
EPS - FRS 3 (p)		20.3	4.3	8.1	10.9	12.6	1.2	17.1
Dividend per share (p)		1.00	1.00	1.25	1.50	1.75	1.93	2.12
Gross Margin (%)		58.1	52.2	54.1	51.5	54.4	54.6	54.5
EBITDA Margin (%)		19.0	11.4	13.7	13.2	14.4	13.3	16.8
Operating Margin (before GW and except.) (%)		16.8	8.1	10.2	9.8	10.7	8.7	12.0
BALANCE SHEET								
Fixed Assets		68,325	69,398	67,067	67,497	78,072	77,742	75,292
Intangible Assets		21,255	21,040	20,040	20,806	26,369	26,239	23,939
Tangible Assets		2,722	2,927	2,439	2,316	2,389	2,189	2,039
Goodwill		43,540	44,610	43,952	43,541	48,793	48,793	48,793
Other		808	821	636	834	521	521	521
Current Assets		32,418	25,523	29,535	33,734	43,695	48,503	53,540
Stocks		0	0	0	0	0	0	0
Debtors		30,322	25,251	28,888	31,839	40,923	41,847	42,254
Cash		2,096	272	647	1,895	2,772	6,656	11,286
Current Liabilities		(48,043)	(39,272)	(40,278)	(32,886)	(36,332)	(33,959)	(31,694)
Creditors		(8,797)	(5,842)	(7,218)	(7,640)	(8,324)	(8,636)	(8,771)
Other Creditors		(21,468)	(19,379)	(18,799)	(21,803)	(24,632)	(24,632)	(22,232)
Short term borrowings		(17,778)	(14,051)	(14,261)	(3,443)	(3,376)	(691)	(691)
Long Term Liabilities		(5,797)	(4,524)	(3,719)	(14,850)	(12,025)	(19,336)	(18,686)
Long term borrowings		0	(32)	(14)	(10,531)	(8,272)	(16,133)	(16,133)
Other long term liabilities		(5,797)	(4,492)	(3,705)	(4,319)	(3,753)	(3,203)	(2,553)
Net Assets		46,903	51,125	52,605	53,495	73,410	72,950	78,452
CASH FLOW								
Operating Cash Flow		7,284	8,022	5,352	9,600	5,498	8,668	13,167
Net Interest		(839)	(820)	(848)	(950)	(783)	(1,100)	(700)
Tax		(1,312)	(1,217)	290	(264)	(688)	(1,460)	(2,094)
Capex		(3,160)	(4,613)	(4,487)	(4,564)	(5,573)	(5,500)	(5,050)
Acquisitions/disposals		(7,132)	(1,917)	(129)	(1,998)	(7,386)	(1,270)	0
Financing		5,026	2,677	277	69	13,175	0	0
Dividends		(214)	(286)	(316)	(397)	(477)	(630)	(693)
Net Cash Flow		(347)	1,846	139	1,496	3,766	(1,292)	4,630
Opening net debt/(cash)		15,486	15,682	13,811	13,628	12,079	8,876	10,168
HP finance leases initiated		0	0	0	0	0	0	0
Other		151	25	44	53	(563)	0	0
Closing net debt/(cash)		15,682	13,811	13,628	12,079	8,876	10,168	5,538

Source: K3 Business Technology Group, Edison Investment Research

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