Investors' Chronicle | Alpha

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Alpha small company research

27 October 2022

Making the most of the UK's restructuring challenge

It pays to seek out companies that are likely to benefit from earnings tailwinds in the current market environment. A below the radar professional advisory service provider that assists UK small and medium-sized enterprises does exactly that.

Simon Thompson's view:

'The UK economy faces challenging trading conditions as consumers rein in their spending and corporates battle with higher input costs. Insolvencies are already rising sharply, meaning there is demand for the services of one Aim-traded company, which is seeing a sharp uptick in business for its corporate restructuring unit. The group also has a growing recurring revenue stream from tax advisory activities, and is working on a bumper pipeline of M&A transactions as SME (small to medium enterprises) business owners sell up. Rated on a modest forward PE ratio of 12 and offering a prospective dividend yield of 6 per cent, its solid trading prospects are being undervalued.'

Source: FactSet

Bull points

1. Diversified revenue streams
2. The restructuring unit offers counter cyclical defensive qualities
3. SME sales business is largely uncorrelated to larger M&A market
4. High recurring income stream from tax advisory services
5. Organic growth complemented by bolt-on acquisitions
6. Track record of integrating acquisitions
7. Strong first-quarter trading was significantly ahead of the prior year
8. Pipeline of transactions supports profit estimates
9. High cash profit margins
10. Strong cash conversion supports a progressive dividend policy
11. The directors hold 32 per cent of the shares

Bear points

1. Low liquidity in the shares
2. Macroeconomic uncertainty
3. Acquisitions carry integration risk
4. Dependency on key individuals

K3 Capital Group (K3C)	
Ticker	K3C
Current price	252.5p
Bid-offer spread	250 to 255p
Target price	325p
Market cap	£186mn
52 week high	362.5p
52 week low	215p
Net cash	£11.6mn (31 May 2022)
Net asset value	£66.5mn (includes intangible assets of £57.2mn)
Shares in issue	73.5mn
Financial year end	31 May
Next event	pre-close trading update in mid-December 2022
Website	k3capitalgroupplc.com

K3 Capital Group is a provider of professional advisory services that assists UK small and medium-sized enterprises (SMEs) across three key business segments:

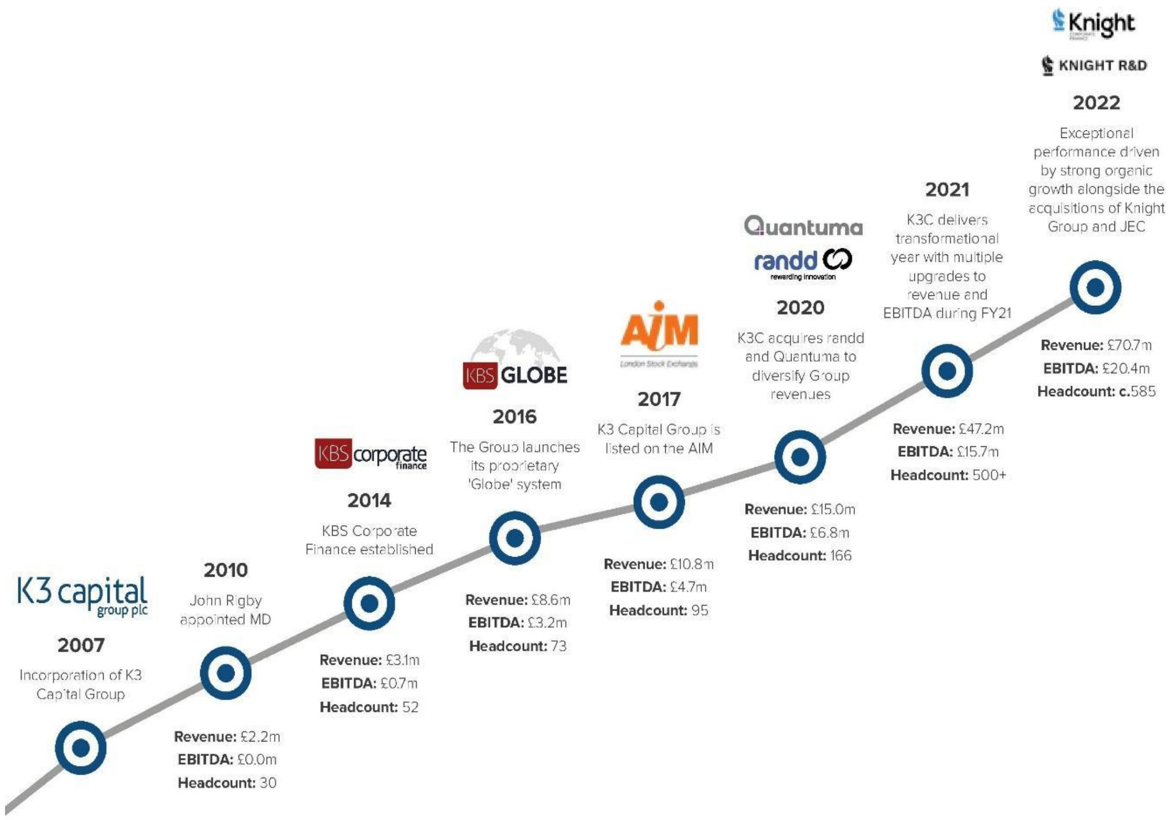
Business sales: Company sales; corporate finance; brokerage services; transaction services and off-market acquisitions.

Restructuring: Formal insolvency appointments; restructuring advisory; pension scheme restructuring; insolvency advice; stakeholder management and turnaround services; creditor representation and liquidations; forensic accounting and expert witness; and corporate and trustee advisory.

Tax advisory: Research & Development (R&D) tax credit advisory; tax investigations; tax planning; and tax advisory for corporate finance transactions.

The group was founded in 2007 to acquire KBS Corporate, a business broker and transfer agent to UK SMEs, and has been led by chief executive and 10.4 per cent shareholder John Rigby since 2010. Buoyed by a combination of organic growth and bolt-on acquisitions, K3 Capital's management team has delivered an impressive track record of growth since listing its shares, at 95p, on London's junior market in March 2017.

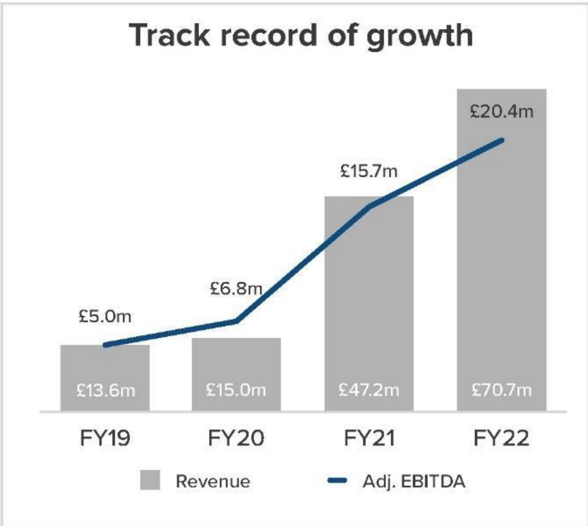
K3 Capital Group history since 2007

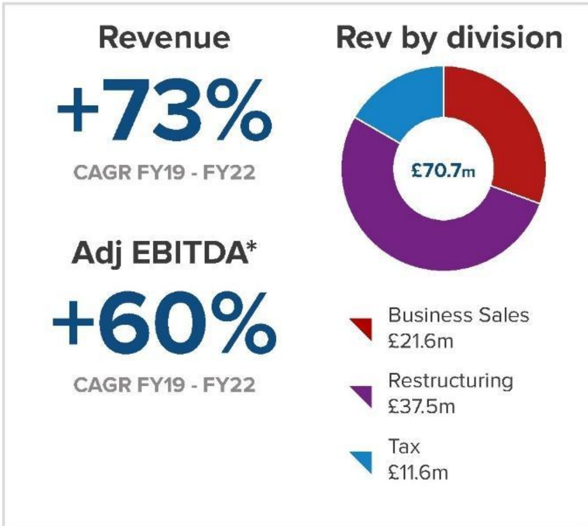


Source: K3 Capital corporate presentation September 2022

In fact, the directors have increased revenue sevenfold to £70.7mn and more than quadrupled earnings, before interest, depreciation and amortisation (Ebitda) to £20.4mn in the subsequent five-year period. The group now employs 585 employees, or six times higher than on Admission to Aim, operating across 23 offices in the UK and six overseas.

Last year was no exception. A few weeks ago, the group reported strong growth across all three divisions in its last financial year to 31 May 2022, a performance that propelled revenue 50 per cent higher to £70.7mn (almost half the growth was organic) and sent Ebitda surging by 30 per cent to £20.4mn on an impressive margin of 29 per cent.

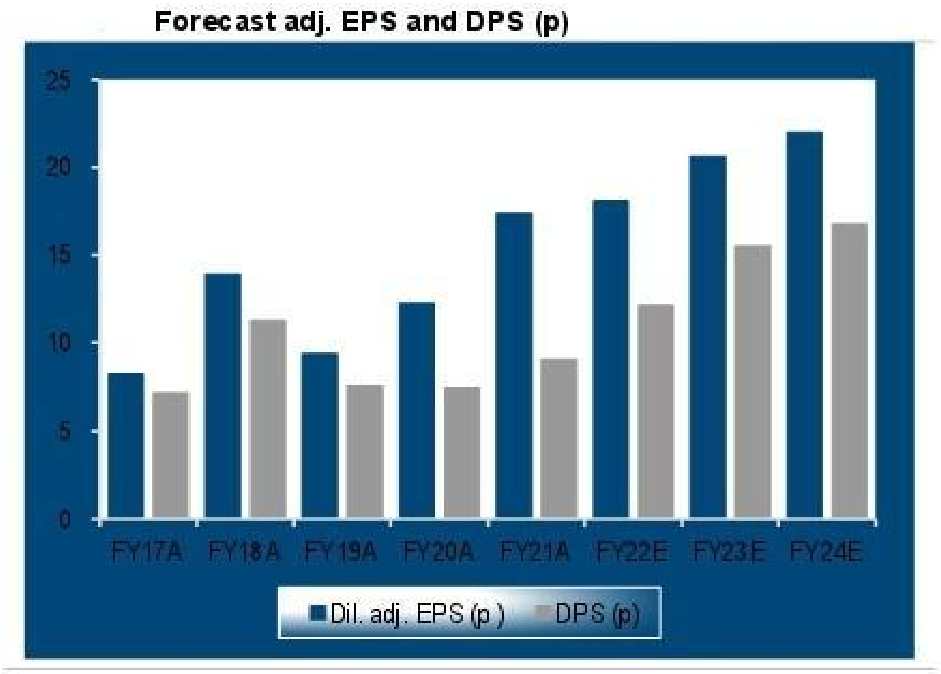




Source: K3 Capital corporate presentation (September 2022)

Full-year underlying earnings per share (EPS) increased by 11 per cent to 20.6p (19.3p on a fully diluted basis), thus enabling the board to hike the dividend per share by a third to 12.1p. Moreover, the directors have committed to raising the pay-out to 15.5p per share in the financial year to 31 May 2023.

Continued below...



Source: Company data, Stifel estimates

On this basis, the prospective dividend yield is 6.1 per cent, which is an attractive income stream in an inflationary environment and one that also offers material dividend support. The shares are also rated on forward price/earnings (PE) ratios of 12.1 (2022/23) and 10.9 (2023/24) based on the fully diluted earnings per share (EPS) estimates of brokerage Stifel. Those are modest multiples for a highly cash-generative group that retains a cash-rich balance sheet boasting net cash of £11.6mn (15.75p a share).

Continued below...

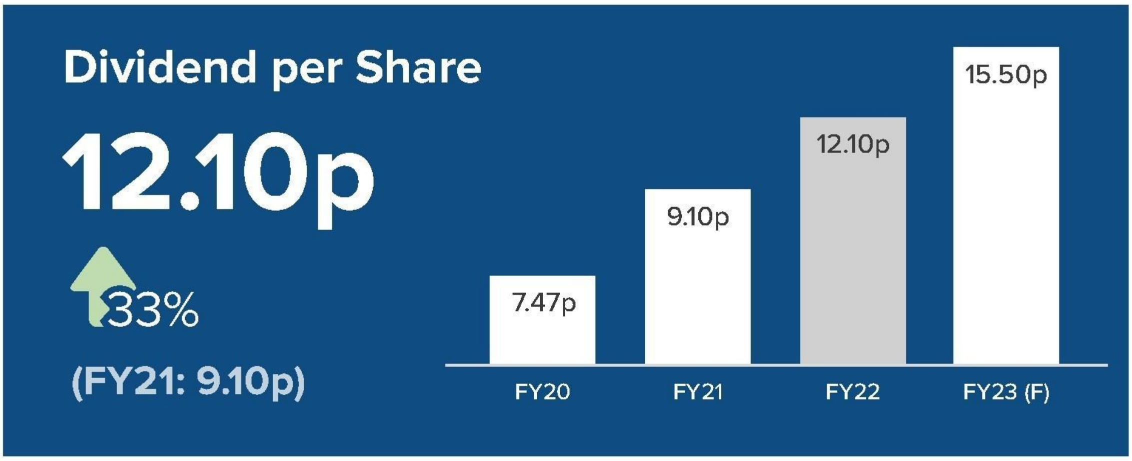
Key profit and loss data (£)	2022A	2023E	2024E	2025E
Revenue	70.7	79.2	86.9	93.6
EBITDA	20.5	22.3	25.0	26.9
EBITDA margin (%)	29.0	28.2	28.8	28.8
EBITA	18.8	20.6	23.1	24.9
EBITA margin (%)	26.6	25.9	26.6	26.6
Net Interest	(0.3)	(0.4)	(0.4)	(0.4)
Interest cover (x)	51.2	51.4	56.4	60.7
PBT adj	18.7	20.2	22.8	24.5
Tax rate (%)	19.7	19.5	19.5	19.5
EPS Adjusted (p)	19.3	20.8	23.2	24.9
EPS adj growth (%)	11.2	7.7	11.7	7.3
DPS (p)	12.1	15.5	17.1	18.4
FCF per share (p)	11.2	19.0	21.6	23.8
Revenue growth (%)	49.8	12.2	9.7	7.7

Key cash flow data (£)	2022A	2023E	2024E	2025E
Operating profit	18.8	20.6	23.1	24.9
Working capital	(4.8)	(1.2)	(1.2)	(0.8)
Operating cash flow	14.9	21.1	23.9	26.1
Capex	(1.2)	(1.3)	(1.4)	(1.6)
Net interest	(0.2)	(0.2)	(0.2)	(0.2)
Taxes paid	(4.1)	(3.9)	(4.4)	(4.8)
FCF	8.7	14.9	17.0	18.8
Dividends	(7.4)	(9.7)	(11.8)	(13.0)
Net debt/(cash)	(11.6)	(12.7)	(16.8)	(21.5)
Net debt/EBITDA (x)	(0.6)	(0.6)	(0.7)	(0.8)

Key balance sheet (£)	2022A	2023E	2024E	2025E
Net debt/(cash)	(11.6)	(12.7)	(16.8)	(21.5)

Source: Stifel (27 September 2022)

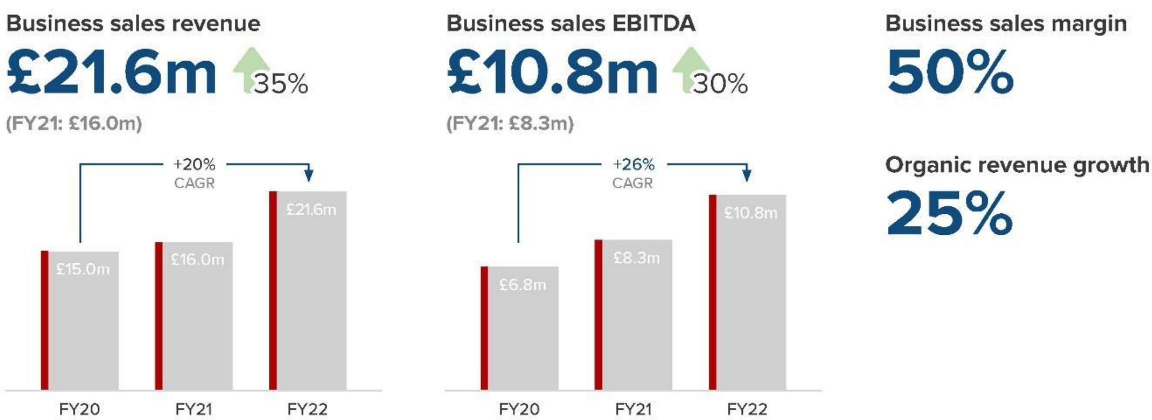
Bearing in mind the growth projections, the directors reassuringly reported buoyant first-quarter trading in the three months to 31 August 2022, forecasting turnover to exceed £20mn to produce Ebitda of £6.5mn, both metrics being significantly ahead of the same period of 2021. There are also reasons to be confident that second-quarter trading will be well ahead of last year when the group releases its interim pre-close trading update, in mid-December 2022.



Source: K3 Capital corporate presentation (September 2022)

Business Sales firing on all cylinders

K3 Capital's Business Sales division delivered a record year of performance, mandating more sellers and completing more transactions than ever before. Divisional revenue increased by 35 per cent to £21.6mn (25 per cent on a like-for-like basis excluding acquisitions) which in turn propelled Ebitda up by 30 per cent to £10.8mn on an eye-catching margin of 50 per cent.



Source: K3 Capital corporate presentation (September 2022)

The ongoing organic growth is being driven by a unique proprietary data driven marketing platform that has been carefully designed to drive growth (rather than relying on positive macroeconomic trends) and deliver increasing volumes of sell-side clients, new buyer registrations and, ultimately, overall transaction numbers. New client mandates and completed transactions have surged by more than half in the last two financial years.

Developed over the past decade, and run by a team of technology engineers, the group's technology platform, K3 Globe, uses a database of more than 6.2mn UK client targets, 13.3mn directors and shareholders, and 118,000 historic corporate transactions, that are extensively profiled and refined on a continuous basis. The data is honed to create a valuable direct marketing database that is then used to identify and target potential business clients through a volume driven sales and marketing approach. The scale and proprietary nature of the database creates a major barrier to entry for new competitors. The business also uses a referral network, K3 Hub, of more than 2,000 accountancy professionals from 1,000 plus member firms to drive potential business sales opportunities.

Effectively, by adopting this strategy, management has created a business that is both sector and buyer type agnostic, with performance very much underpinned by its volume brands (Knightsbridge and KBS Corporate), ensuring that larger corporate finance transactions are still seen as upside opportunities. It also ensures that the business continues to be driven by its contingent fee pipeline, which in turn provides increasing visibility of future revenues.

The strategy is certainly working as K3 Capital is ranked as the UK's number one adviser in its field since IPO, advising on 937 corporate transactions between 2017 and 2021 (source: Refinitiv), including 279 deals in 2021 (source: PitchBook), or almost double the number of its nearest rival, Grant Thornton.

The UK's number one adviser since 2017

UK'S LEADING CORPORATE M&A ADVISERS 2017 - 2021 — REFINITIV

RANK	ADVISER	DEALS
1	K3 Capital Group PLC	937
2	Rothschild & Co	561
3	KPMG	491
4	PricewaterhouseCoopers	482
5	Grant Thornton	436
6	Deloitte	357
7	RSM Corporate	263
8	Benchmark International	259
9	Houlihan Lokey	252
10	BDO	250
11	Ernst & Young	231
12	Baker Tilly	199
13	Lazard	176
14	Oaklins	175
15	Clearwater International	167
16	JP Morgan	167
17	Goldman Sachs	164
18	Lincoln International	156
19	Jefferies LLC	118
20	Alantra Partners	83

FULL YEAR 2021 | UK & IRELAND — PitchBook

RANK	ADVISER	DEALS
1	K3 Capital Group PLC	279
2	Grant Thornton	149
3	BDO	145
4	RSM Corporate	131
5	KPMG	98
6	PricewaterhouseCoopers	94
7	Benchmark International	73
8	Ernst & Young	72
9	Houlihan Lokey	51
10	FRP Advisory	43

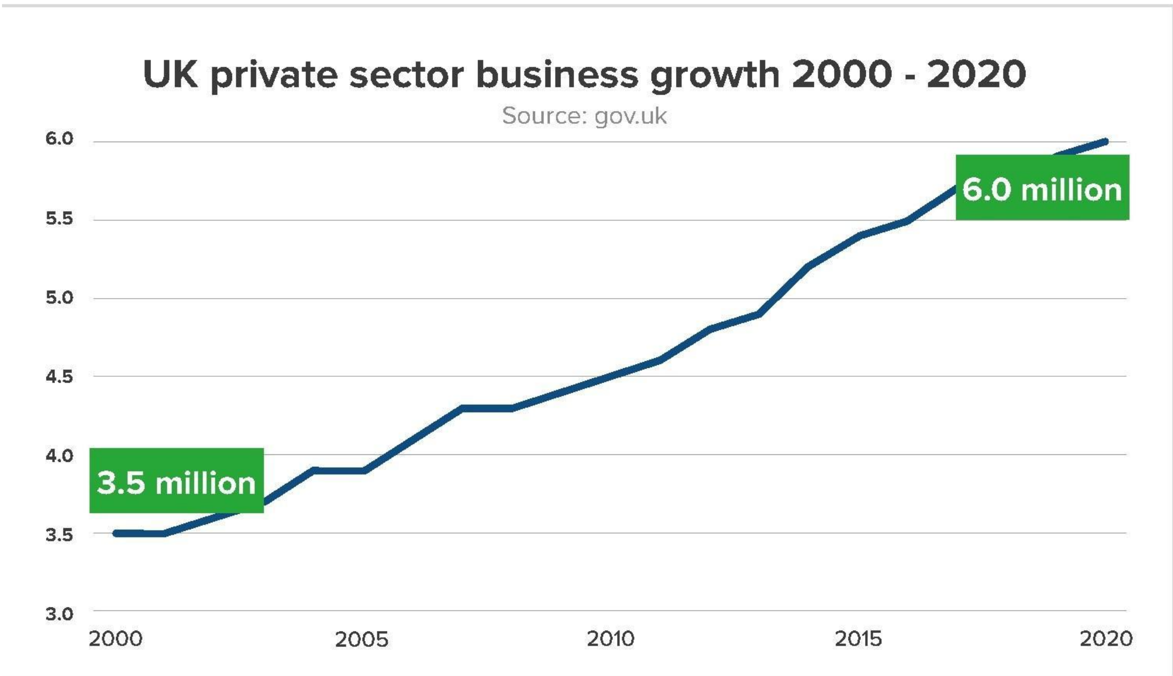
H1 2022 // MM4 - VALUES UP TO US$500M — REFINITIV

RANK	ADVISER	DEALS
1	K3 Capital Group PLC	149
2	Grant Thornton	99
3	PricewaterhouseCoopers	61
4	Rothschild & Co	60
5	Houlihan Lokey	36
6	Ernst & Young	35
7	Benchmark International	33
8	Clearwater International	29
9	KPMG	26
10	Deloitte	26

Source: K3 Capital corporate presentation September 2022

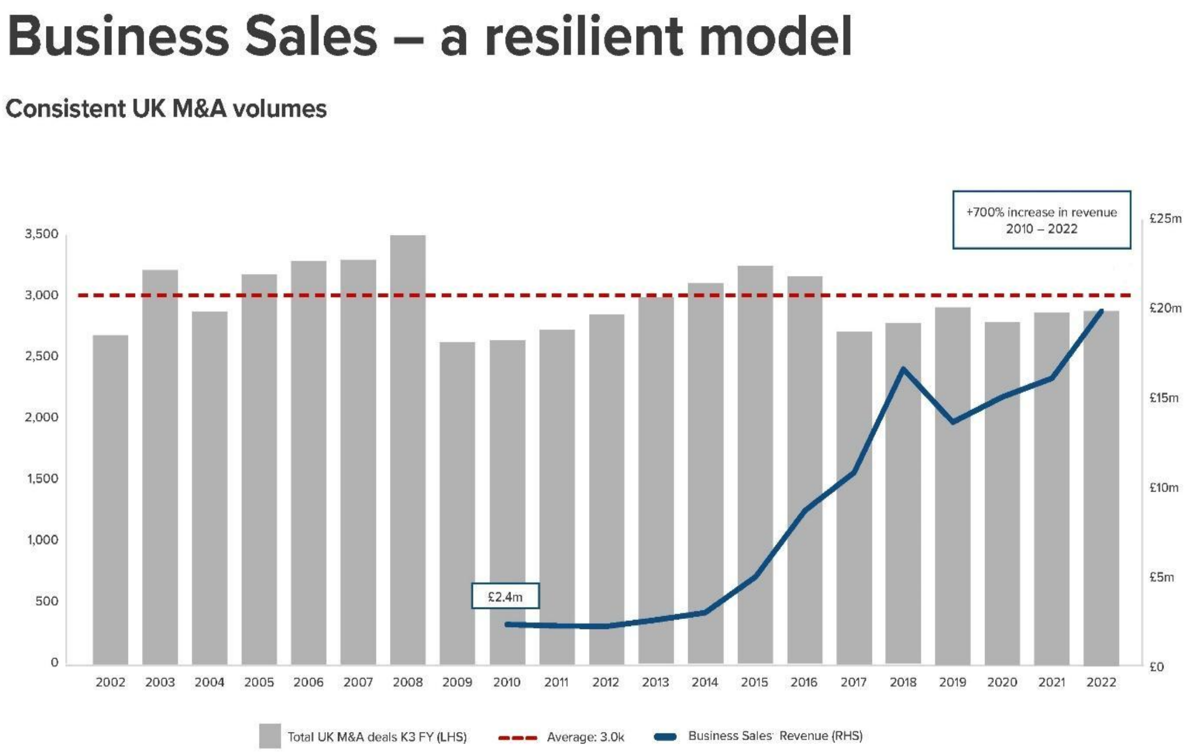
The record divisional performance in the 2022 financial year was also assisted by the July 2021 acquisition of Knight Corporate Finance, a business that contributed £0.3mn of pre-tax profit and £0.5mn of revenue to the group result, an outcome that more than justifies the £3.5mn acquisition price. Furthermore, Knight Corporate Finance has added sector expertise within the telecoms and technology areas, in line with the group's strategy to acquire complementary and value-accretive businesses to build out its existing SME-focused service lines.

Of course, investors may be concerned that transaction volumes could suffer as the UK economy weakens. However, the motivations of sellers of SME businesses are largely uncorrelated to activity in the larger mergers & acquisition (M&A) market, the decision to sell being driven by factors such as retirement, divorce, health and value realisation. Also, there has been a boom in the number of UK private sector businesses in the past 20 years, a factor that is positive for K3 Capital's addressable market, the company being a volume player focused on SME and micro-SME transactions.



Source: gov.co.uk

It's also reassuring that total M&A volumes across the UK market have been resilient over the past 20 years, averaging around 3,000 transactions per year, adding substance to the view that M&A activity across K3 Capital's targeted high-volume SME market should hold up well through a period of weak economic performance in the UK economy. Despite this year's economic uncertainty, the division entered the 2022/23 financial year with a record level of transactions in the legal process, adding weight to the board's expectation of delivering another year of strong organic growth. Excluding acquisitions, K3 Capital ended its 2021/22 financial year having arranged 25 per cent more buyer meetings with clients and reported a 22 per cent increase in the volume of offers received by them, positive trends that suggest the pipeline of transactions carried through to the 2022/23 financial year are well underpinned.



Source: Zephyr – deals include completed and announced acquisitions, Management Buy-Ins (MBIs) and Management Buy-Outs (MBOs) where the target company is UK based, by K3 Capital Group financial year.

Restructuring division

Trading as Quantuma, the group operates a leading business advisory firm which works with SMEs to deliver partner led solutions and help clients take advantage of opportunities and overcome a range of operational and financial challenges.

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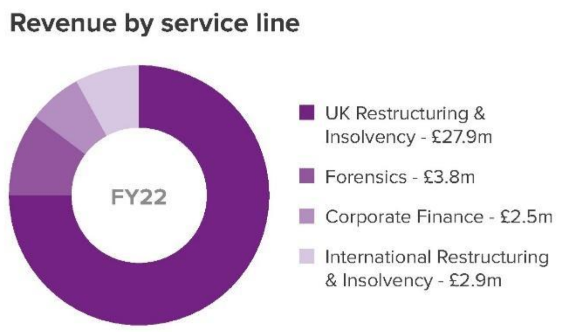
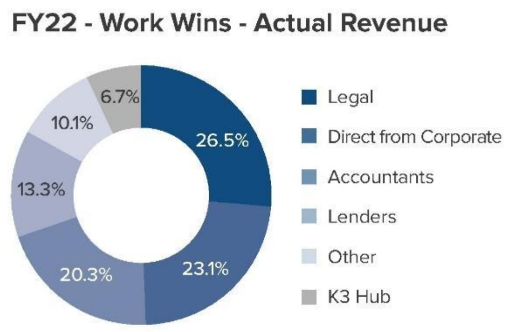
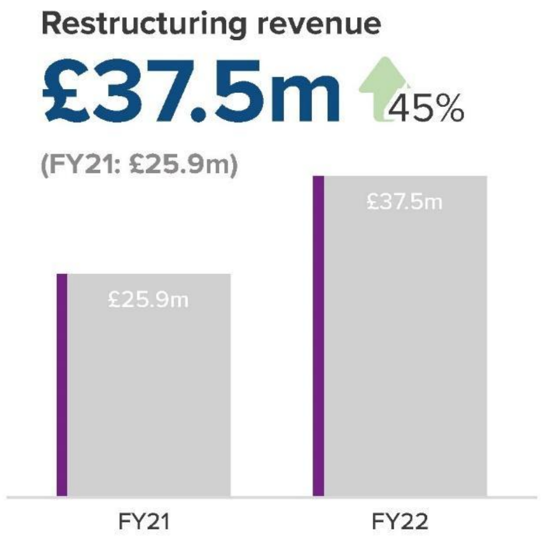
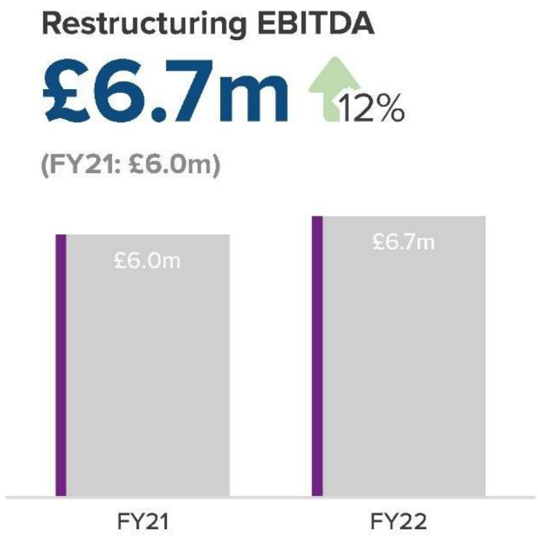




Source: K3 Capital Group corporate presentation September 2022

In the 2021/22 financial year, the unit posted double-digit organic growth and made the small acquisition of Professional Marketing Insight Limited (trading as JE Consulting), a full-service marketing agency specialising in digital and creative services to SMEs in the accountancy, legal and healthcare sectors.

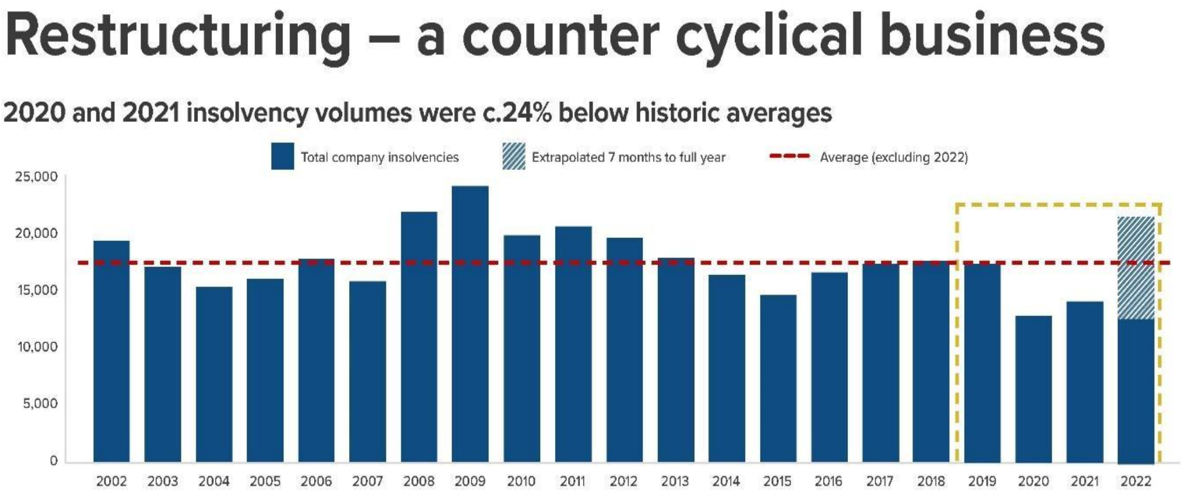




Source: K3 Capital Group corporate presentation September 2022

Despite facing subdued insolvency market conditions in the trading period, and making investment into new overseas offices, the division still reported 45 per cent higher annual revenues of £37.5mn (21 per cent organic growth) and 12 per cent higher Ebitda of £6.7mn. The international expansion has seen the launch of new offices in Singapore, Dubai and Poland,

and expansion of its Cayman office into the British Virgin Islands to establish a greater global presence.



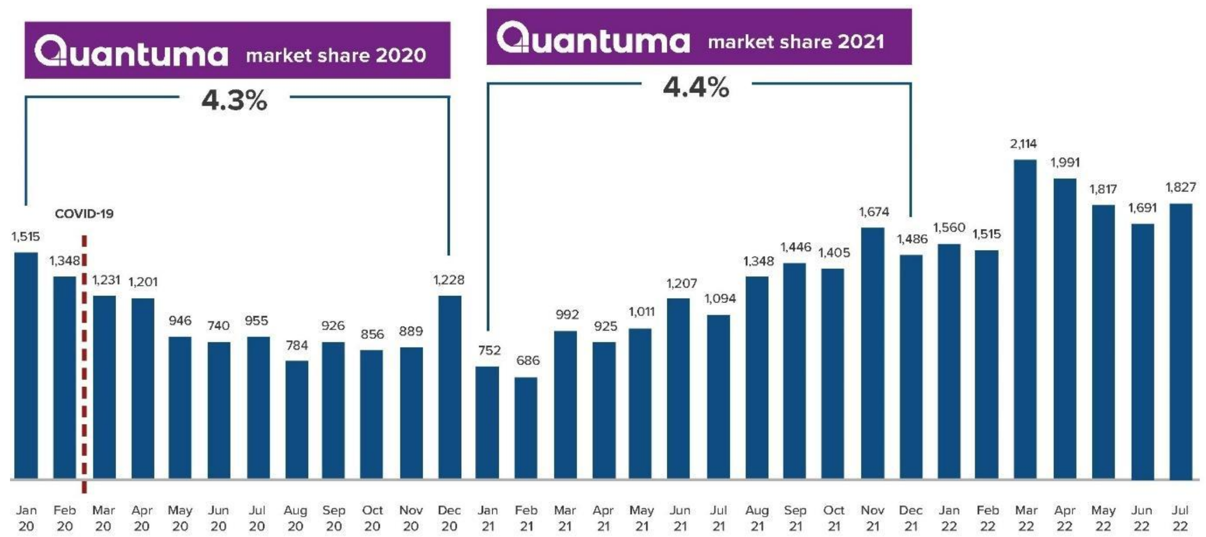
Source: The Insolvency Service

The lag in profits also reflects investment in the division's fee earner base, up from 225 to 250 employees, in anticipation of a significant increase in activity levels. That's because demand in the UK insolvency market is expected to grow materially following the removal of UK government support that was offered to SMEs during the Covid-19 pandemic, and due to the challenging economy. The latest S&P Global/Cips flash UK composite output index, a measure of activity in the private sector, dropped to a 21-month low this month and remains in contraction, highlighting mounting recessionary pressures facing the UK economy.

In addition, the dramatic repricing of UK government debt this year is expected to accentuate corporate insolvencies as zombie companies that had been kept on life support during the zero-interest rate policy environment face their day of reckoning. The ongoing rise in the Bank of England Base Rate also means that more over indebted companies are in danger of breaching their interest cover covenants, especially as input cost pressures continue to erode trading profits across many sectors.

This is an unhappy backdrop, but one that is positive for K3 Capital's restructuring division, which offers a wide range of insolvency and restructuring services, including formal insolvency appointments, creditor representation, and liquidations.

Insolvency Service Monthly Volumes (2020 to 2022)



Source: Insolvency Service

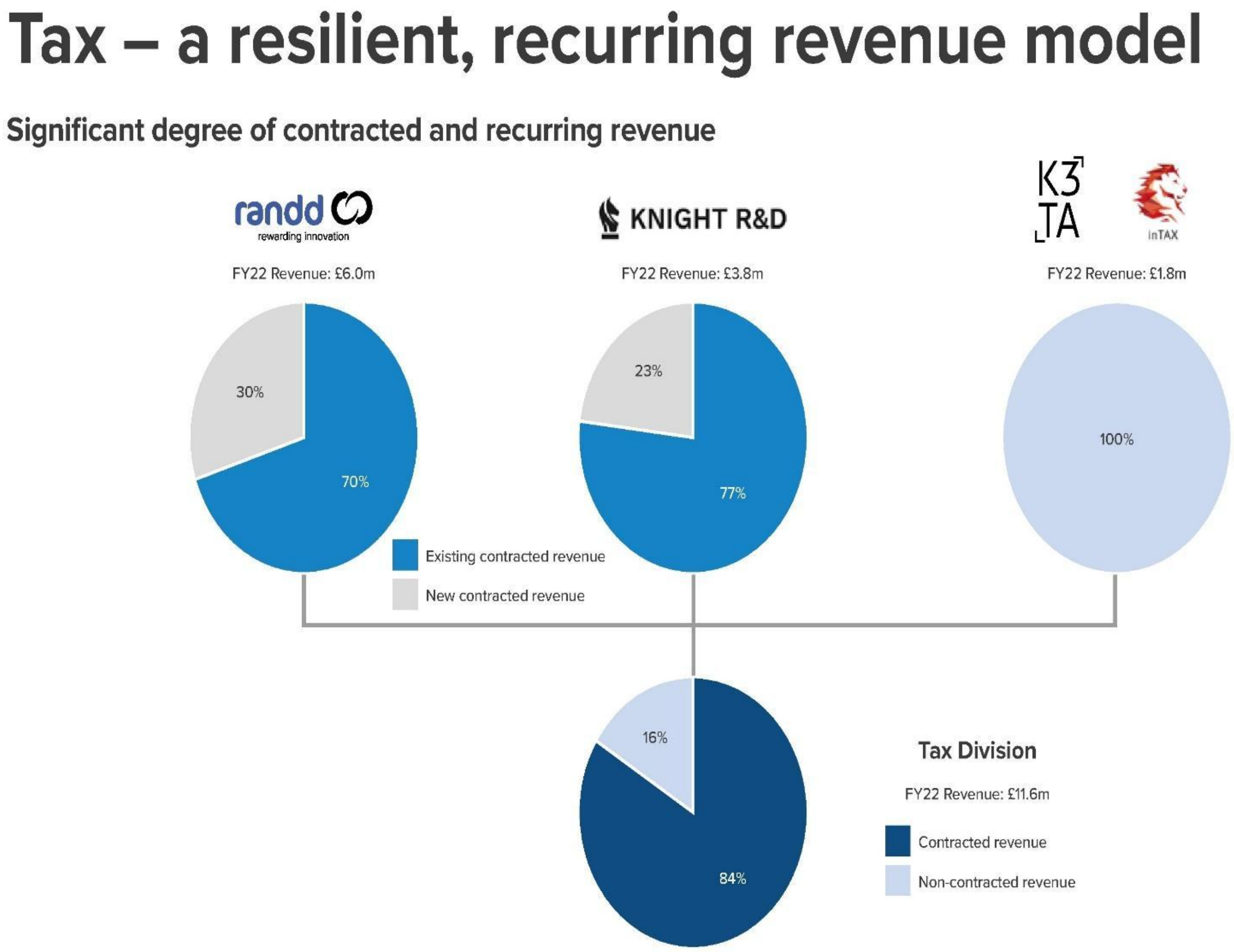
Importantly, there is growing evidence that the headwinds previously faced by the restructuring division are turning into strong tailwinds. Indeed, K3 Capital's management reported in their recent outlook statement "positive momentum and uplift in appointment levels [in the first quarter of the 2022/23 financial year] in a market that is clearly gathering momentum and returning to, if not beyond, pre-pandemic levels".

To put the upside potential for this business unit into perspective, in the final three months of K3 Capital's 2021/22 financial year, covering the period from 1 March to 31 May 2022, there were 5,922 insolvencies in the UK. That's double the number in the same three-month period of 2021, and 35 per cent higher than pre-pandemic in 2019, according to UK insolvency statistics. Given that insolvency volumes were almost a quarter below their average level during 2020 and 2021, there is obvious scope for strong earnings momentum to develop.

Also, the counter cyclical income streams from K3 Capital's restructuring and insolvency activities (accounting for around three quarters of the division's total revenue in 2021/22) are supplemented by growing work in the areas of forensic accounting, corporate finance advisory and international restructuring and insolvency (around a quarter of divisional revenue in aggregate).

Tax Advisory

The group's tax advisory business reported bumper results last year on the back of both organic and acquisitive growth, reporting 123 per cent increase in revenue to £11.6mn and 90 per cent higher Ebitda of £5.9mn.



Source: K3 Capital Group corporate presentation September 2022

It's a highly profitable business, earning a cash profit margin of 51 per cent. Highly visible contracted recurring revenue is strong, accounting for 84 per cent of total and the 1,400 clients within the group's Tax Advisory R&D brands are contracted typically on three to five-year terms.

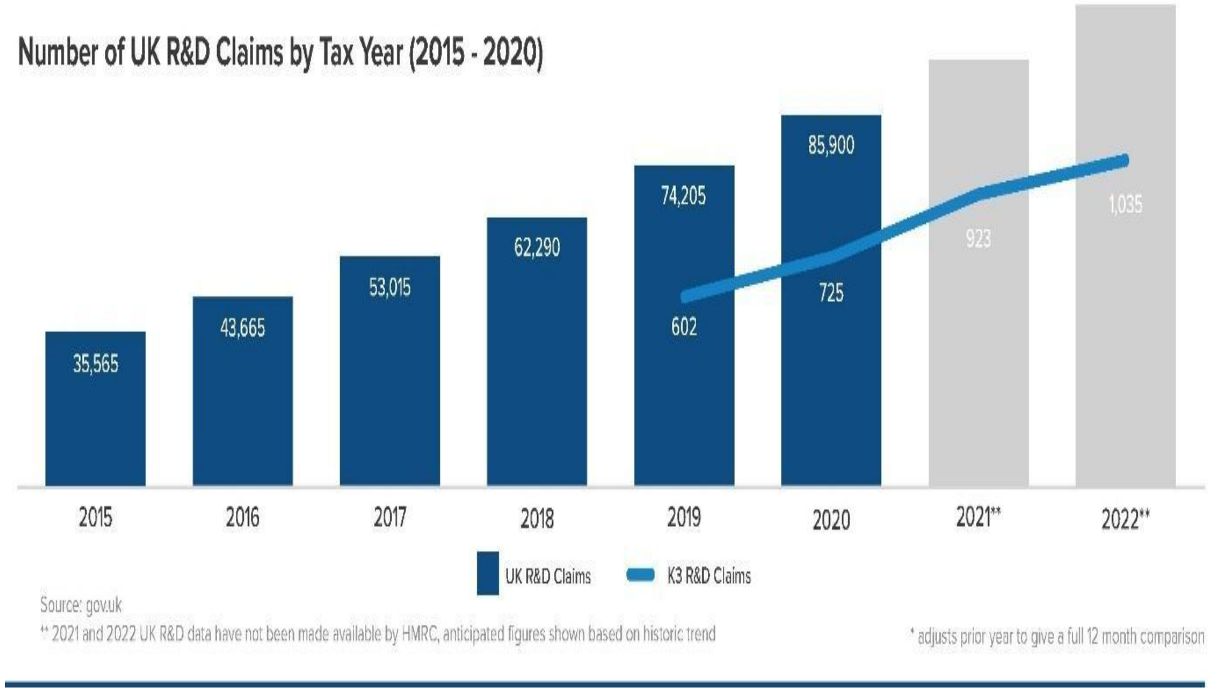
Continued below...

Source: K3 Capital Group corporate presentation September 2022

Acquisitions are adding to that recurring revenue stream. In July 2021, the business acquired Knights R&D, a specialist in tax research and development claims for SMEs, for £13.6mn. In the 46 weeks from completion to 31 May 2022, Knights R&D contributed pre-tax profit of £2.5mn on revenue of £3.8mn. However, for the full 12-month period the acquisition would have contributed pre-tax profit of £2.9mn on revenue of £4.4mn, implying K3 Capital paid a modest multiple of less than five times operating profit.

The combined £17mn acquisition cost of both Knights R&D and Knights Corporate Finance was part funded by a placing at 340p a share that raised £10mn and covered almost 90 per cent of the £11.2mn cash consideration payable on completion. The balance of £3.7mn was settled in shares and contingent consideration of £2.7mn for Knights R&D dependent on an earn-out arrangement.

In addition, the group launched K3 Tax Advisory, a new high margin tax advisory service focused on corporate finance, restructuring and employer tax solutions. It is led by two managing directors, who are both 'Big Four' trained transaction tax specialists with senior leadership experience in corporate finance, investment banking and private equity organisations. The new business delivered £0.8mn of revenue in its first 11 months of trading, the contribution being one of the drivers behind the 35 per cent organic growth in divisional revenue. This also highlights the group's strategy of developing new income streams that enable cross selling opportunities across the group.

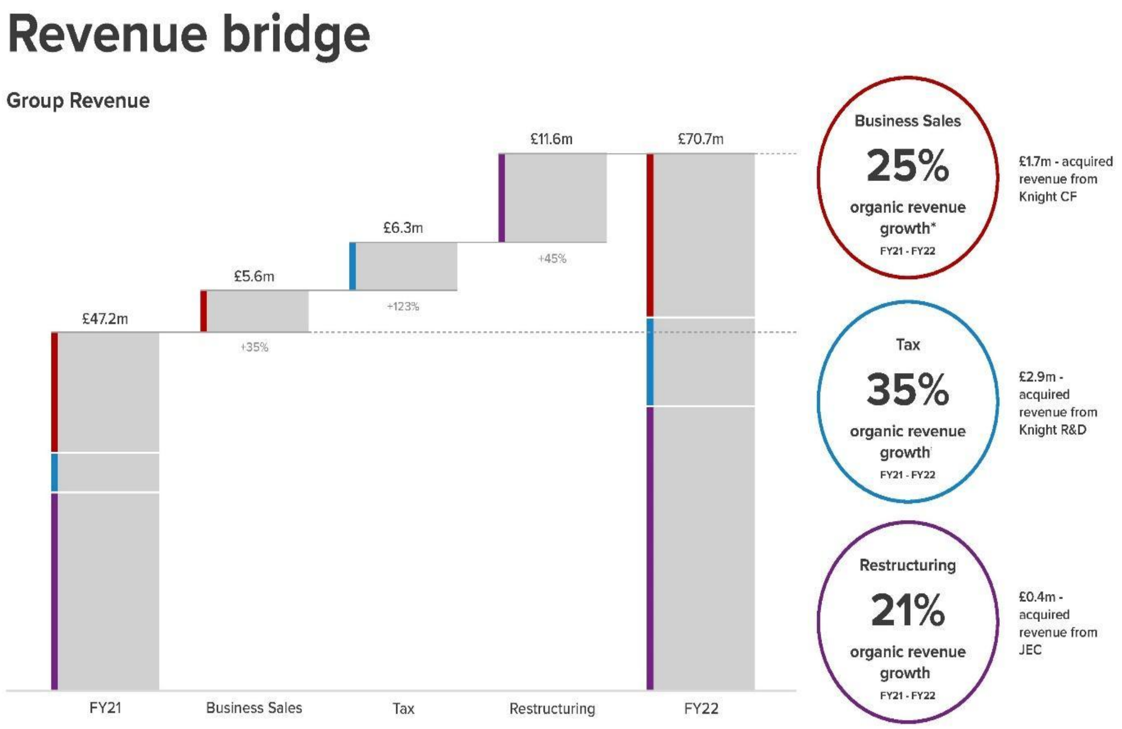


Source: K3 Capital Group corporate presentation September 2022

Other positive factors include a nine per cent increase in HMRC UK R&D tax submissions made by rrand, a Midlands based, R&D Tax Credit Specialist servicing clients across the whole of the UK; more efficient internal processes; and the introduction of a direct marketing engine that has led to a material increase in new client wins. Although 2021 and 2022 UK R&D data has not been made available by HMRC, the trend in this market remains positive as does the growth that K3 Capital's tax advisory unit is delivering.

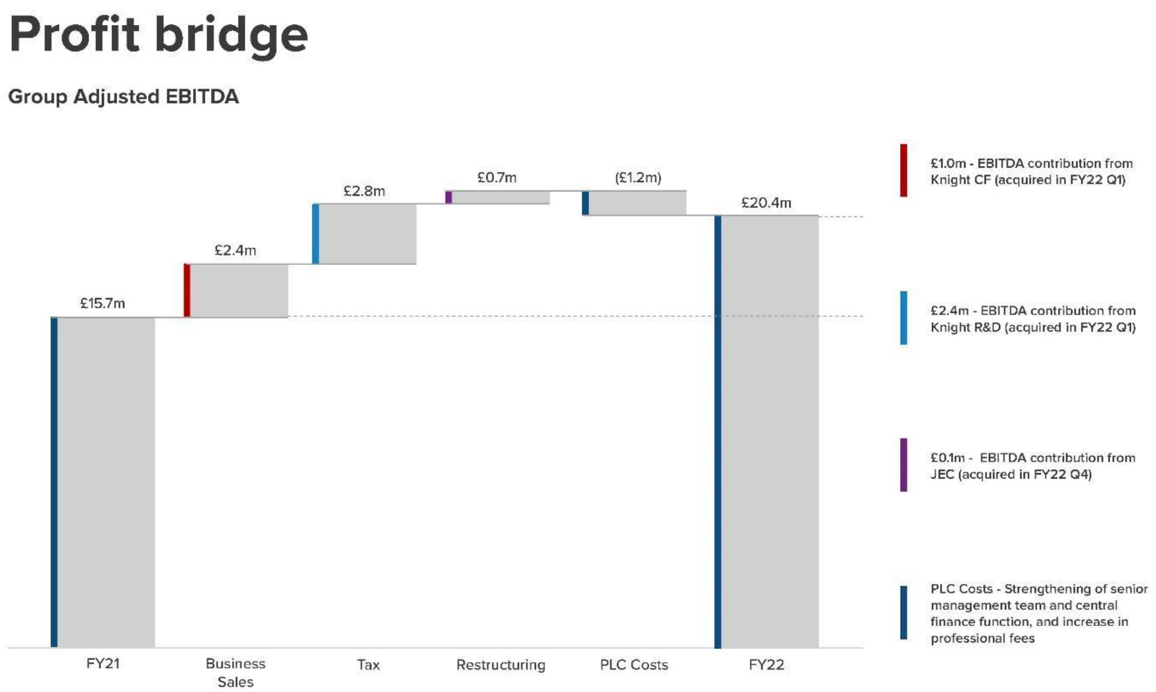
Strong financials point to another year of growth

K3 Capital's recent annual results release not only revealed the positive contribution from acquisitions made in the last financial year, but underlying revenue growth exceeding 20 per cent from each division.



Source: K3 Capital Group corporate presentation September 2022

In turn, this revenue growth has propelled Ebitda materially higher on a strong cash profit margin of 29 per cent.



Source: K3 Capital Group corporate presentation September 2022

It's worth noting that K3 Capital increased its average headcount by a third, to 545 employees over the year, which boosted payroll costs by 36 per cent to £37.9mn. That accounted for more than two-thirds of the £55.1mn cost base. Acquisitions in the period added £3.9mn to costs, but the main increase reflected a full 12-month of costs from acquisitions that had been made in the 2020/21 financial year.

Year ended 31 May 2022 £'000	2022	2021
Revenue	**70,650**	47,171
Cost of sales	**(24,725)**	(13,724)
Gross profit	**45,925**	33,447
Administrative expenses	**(31,610)**	(25,498)
Expected credit loss	**(1,339)**	(211)
Other income	**18**	1
Adjusted EBITDA	**20,442**	15,710
Share-based payments	**(263)**	(145)
Depreciation of tangible and right of use assets	**(1,258)**	(680)
Amortisation of intangible assets	**(2,320)**	(1,254)
Transaction costs	**(1,420)**	(1,955)
Deemed remuneration	**(2,187)**	(3,937)
Operating profit	**12,994**	7,739
Share of results of joint ventures	**64**	61
Finance income	**24**	3
Finance costs	**(368)**	(198)
Profit before taxation	**12,714**	7,605
Taxation	**(3,179)**	(2,439)
Profit for the financial year	**9,535**	5,166

Source: K3 Capital annual report 2022

So, with the benefit of a full 12-month contribution from the acquired businesses made in the last financial year, a strong pipeline of transactions for the Business Sales division, high recurring revenue from Tax Advisory and a likely surge in business from the Restructuring division, it's reasonable to expect decent growth in the current financial year, as analysts at Stifel are forecasting.

Financial forecasts

Key profit and loss data (£)				
	2022A	**2023E**	**2024E**	**2025E**
Revenue	70.7	79.2	86.9	93.6
EBITDA	20.5	22.3	25.0	26.9
EBITDA margin (%)	29.0	28.2	28.8	28.8
EBITA	18.8	20.6	23.1	24.9
EBITA margin (%)	26.6	25.9	26.6	26.6
Net Interest	(0.3)	(0.4)	(0.4)	(0.4)
Interest cover (x)	51.2	51.4	56.4	60.7
PBT adj	18.7	20.2	22.8	24.5
Tax rate (%)	19.7	19.5	19.5	19.5
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EPS adj growth (%)	11.2	7.7	11.7	7.3
DPS (p)	12.1	15.5	17.1	18.4
FCF per share (p)	11.2	19.0	21.6	23.8
Revenue growth (%)	49.8	12.2	9.7	7.7
Key cash flow data (£)				
	2022A	**2023E**	**2024E**	**2025E**
Operating profit	18.8	20.6	23.1	24.9
Working capital	(4.8)	(1.2)	(1.2)	(0.8)
Operating cash flow	14.9	21.1	23.9	26.1
Capex	(1.2)	(1.3)	(1.4)	(1.6)
Net interest	(0.2)	(0.2)	(0.2)	(0.2)
Taxes paid	(4.1)	(3.9)	(4.4)	(4.8)
FCF	8.7	14.9	17.0	18.8
Dividends	(7.4)	(9.7)	(11.8)	(13.0)
Net debt/(cash)	(11.6)	(12.7)	(16.8)	(21.5)
Net debt/EBITDA (x)	(0.6)	(0.6)	(0.7)	(0.8)
Key balance sheet (£)				
	2022A	**2023E**	**2024E**	**2025E**
Net debt/(cash)	(11.6)	(12.7)	(16.8)	(21.5)

Source: Stifel (27 September 2022)

Assuming a slight contraction in group cash profit margin from 29 to 28.2 per cent to reflect a higher contribution in the mix from the lower margin (around 20 per cent) Restructuring unit, then Ebitda is expected to rise from £20.5mn to £22.3mn – that's on revenue up from £70.7mn to £79.2mn in the 12 months to 31 May 2023. However, with costs relatively fixed – K3 has already made investment in staff ahead of the recovery in trading in Restructuring and absorbed new office opening costs in overseas territories – Stifel expects £1.5mn of the

£1.8mn increase in Ebitda to drop through to pre-tax profit line, hence its £20.2mn pre-tax profit forecast for the current financial year. On this basis, expect fully diluted EPS of 20.8p.

The operational gearing (companies where a high proportion of costs are fixed see profits rise and fall more dramatically in line with changes in revenue, so are said to be operationally geared) effect is more pronounced the following year when the broker expects almost all the incremental forecast £2.7mn increase in Ebitda generated from £7.7mn of additional revenue to boost pre-tax profits to £22.8mn and deliver 12 per cent higher EPS of 23.2p. There could be upside to these estimates as K3 Capital retains a cash-rich balance sheet – net cash of £11.6mn is expected to increase to £12.7mn (May 2023) and £16.8mn (May 2024) – which can be recycled into earnings accretive bolt-on acquisitions.

K3 Capital's free cash flow generation is worth highlighting, too. In the 2021/22 financial year, the group converted 73 per cent of the £20.5mn Ebitda to operating cash flow of £14.9mn. That outcome produced free cash flow of £8.7mn after accounting for capital expenditure, small interest payments and corporation tax. However, with the benefit of tighter working capital management, operating cash flow is expected to rise from £14.9mn to £21.1mn this year, a sum that equates to almost 95 per cent of forecast Ebitda of £22.3mn.

So, with a similar level of capital expenditure (capex), interest payments and tax costs, this means that free cash flow could soar from £8.7mn to £14.9mn (20.2p), implying a free cash flow yield of eight per cent. Moreover, around three-quarters of the £2.7mn incremental forecast increase in Ebitda in the 2023/24 financial year is expected to be converted to free cash flow, hence why Stifel are pencilling in free cash flow of £17mn for the period.

Improving cash flow generation in a positive revenue cycle is positive for dividends, and the board is looking to pay-out a dividend of 15.5p a share in the current year. The £11.4mn cost of this is covered by forecast free cash flow of £14.9mn. Stifel expects the annual dividend to rise to 17.1p (2023/24) and 18.4p (2024/25), underpinned by free cash flow per share of 21.6p and 23.8p, respectively.

On this basis, the prospective dividend yields are 6.1 per cent (2022/23), 6.8 per cent (2023/24) and 7.3 per cent (2024/25), underpinned by free cash flow yields of 7.5 per cent (2022/23), 8.5 per cent (2023/4) and 9.4 per cent (2024/25). This is an attractive income stream and one that should attract investor interest in the current inflationary environment, not to mention provide material share price support.

Furthermore, even though the board are committed to a progressive dividend policy, the group's impressive free cash flow generation means that net cash should continue to build, hence why Stifel are pencilling in closing net cash of £12.7mn (May 2023), £16.8mn (May 2024) and £21.5mn (May 2025). This provides material firepower to make further acquisitions, thus delivering potential upgrades to earnings forecasts which would in turn generate additional free cash flow to support the progressive dividend policy.

Key acquisitions (revenue >£1m) since IPO

Date	Name	Description	Revenue in year prior to acquisition
Jun-20	randd	Specialist in securing R&D tax credits for clients.	£4.25m
Aug-20	Quantuma Advisory	UK focused business advisory firm with services including restructuring and insolvency, corporate finance and forensics.	£23.19m
Feb-21	InTax	Specialist in tax investigations and enquiries.	£1.18m
Jul-21	Knight Corporate Finance Group	Specialist M&A advisory firm within the telecoms and tech sector.	£1.71m
Jul-21	Knight R&D	Specialist R&D tax advisory firm servicing UK SMEs.	£3.16m
Mar-22	JE Consulting	Professional services marketing agency.	£1.5m

Source: Company data

As noted earlier, the shares are hardly expensive, trading on forward PE ratios of 12.1 (2022/23), 10.9 (2023/24) and 10.1 (2024/25). The cash adjusted PE ratios are 11.3 (2022/23), 9.9 (2023/4) and 8.9 (2024/5), bargain multiples that also highlight the potential for management to recycle surplus cash into sensibly priced bolt-on acquisitions to boost future earnings.

Management

The group's non-executive chairman is **Ian Mattioli MBE**, a stalwart of the industry with over 30 years' experience in the financial services sector. He co-founded the Mattioli Woods Group in 1991 where he is chief executive and is responsible for the vision and operational management of the group. Mattioli won the London Stock Exchange AIM Entrepreneur of the Year award in 2007.

Following a career in commercial and corporate banking, chief executive **John Rigby** joined the group as managing director in 2010 and led the business through its successful IPO in 2017. He has over 20 years of operational, sales and commercial management experience within the sector and developed the national sales infrastructure of the group. Rigby has been responsible for driving growth and diversification, and is integral in the development of the low-cost, process driven technology delivery platform.

Chief financial officer **Andrew Melbourne** joined the group in 2012 following a decade in financial accounting roles across various industries including media, leisure and property management. He has played an important part in the IPO and the subsequent acquisitions. Melbourne is a fellow of the Chartered Institute of Management Accountants and has an MSc in Strategic Financial Management.

The group's executive co-founder and vice-chairman **Tony Ford** is a chartered accountant and corporate financier. He was subsequently responsible for the overall strategic direction of the group and, previously as chairman, he oversaw a period of strong growth and internal development.

Executive director **Carl Jackson** is a Chartered Accountant and Licensed Insolvency Practitioner FABP, with over 30 years of restructuring experience. Prior to establishing Quantuma in 2013, he held senior leadership roles in restructuring practice and sat on the board of RSM Tenon.

K3 Capital has four non-executive directors, Stuart Lees, Charlotte Stranner, and one independent director, Martin Robinson.

Stuart Lees joined in September 2015 to assist with the development of the strategic direction of the group. He is a highly respected corporate financier and was previously managing director of Altium and head of UK corporate finance at Arthur Andersen.

Charlotte Stranner is a Chartered Accountant and corporate finance professional. Previously, she was a partner at MXC Capital, an Aim-quoted technology, media and telecoms investor and adviser. Stranner is a fellow of the Institute of Chartered Accountants in England and Wales (ICAEW), non-executive director of Aim-quoted Elixirr International and finance director of Aim-quoted Dianomi.

Martin Robinson is an experienced company director with over 30 years' experience in financial services. He has previously served on the board of several subsidiary companies of Aim-quoted Brooks Macdonald Group, the integrated wealth management group. Robinson is a Fellow of ICAEW and was previously on the AIM Advisory Committee as a founder member, overseeing the development and regulation of the market in 1995. He was appointed to the K3 Capital Group board in July 2017.

In the 2022 financial year, the board were paid total remuneration of £1.78mn, a sum that equates to 20 per cent of the £8.9mn cost of the dividend paid to shareholders. All the board own shares, holding in aggregate 32 per cent of the shares in issue. Income from dividends and capital gains on shareholdings are the major financial incentive for the directors, thus aligning their interests with those of outside shareholders.

Shareholders

Around 64 per cent of the 73.5mn shares in issue are owned by the top-10 shareholders including large stakes held by chief executive John Rigby (10.4 per cent) and co-founder Tony Ford (7.6 per cent). Just under half of the shares are deemed not in public hands. As a result, liquidity is below average. That said, the shares can readily be traded with purchases going through the market within the official spread. However, it would make sense to build a position by making purchases in smaller lot sizes or to ask your broker to deal directly with a market maker to negotiate the best price.

Shareholder register

Name	No. of Ordinary Shares	% of Issued Share Capital
Premier Miton Group PLC	10,271,427	13.98
John Rigby	7,617,895	10.36
Anthony Ford	5,556,228	7.56
Hargreave Hale Ltd	4,142,220	5.64
Grandeur Peak Global Advisors LLC	3,568,949	4.86
AXA Investment Management	3,424,156	4.66
Schroder Investment Management	3,400,000	4.63
Jupiter	3,333,333	4.54
Janus Henderson Investors	2,940,790	4.00
Simon Daniels	2,535,100	3.45

Source: K3 Capital

One consequence of the reduced liquidity is that there is greater volatility in the company's share price. This factor can also work in investor's favour if the newsflow and sentiment is positive. In K3 Capital's case, analysts' estimates look conservative and K3 Capital's management has already stated that the positive trading trends from the last financial year have continued into the first quarter. The forthcoming first half pre-close trading update in mid-December should be well received.

Peers

There are few direct listed rivals to K3 Capital, but perhaps the most appropriate comparison is with its restructuring peers, Begbies Traynor and FRP Advisory.

K3 Capital beats both on its level of profitability, boasting a group Ebitda margin of 28.2 per cent compared to 26.5 per cent (FRP Advisory) and 20.3 per cent (Begbies Traynor) based on broker forecasts for the 2022/23 financial year for all three companies. The group is also rated on a 7 per cent ratings discount to Begbies Traynor and 40 per cent discount to FRP Advisory using an Ebitda multiple to enterprise valuation. The discount is similar on a PE ratio basis.

That seems overly harsh given that FRP Advisory is only forecast to deliver a relatively flat profit performance over the next two financial years, albeit there is upgrade potential in the event of major recovery in insolvency work. By comparison, both Begbies Traynor and K3 Capital are forecast to deliver 20 per cent total EPS growth over the same two-year forecast period.

Peer group comparison

Company	Year End	Share price	Market Capitalisation	Enterprise valuation/ Ebitda (12 months forward)	PE ratio (12 months forward)	Dividend yield (12 months forward)
K3 Capital	**31-May-23**	**252.5p**	**£187mn**	**7.8**	**12.1**	**6.1%**

Restructuring peers

Begbies Traynor	30-Apr-23	131p	£202mn	8.4	13.1	2.9%
FRP Advisory	30-Apr-23	155p	£376mn	13.1	19.9	3.0%

Source: K3 Capital Group - Stifel estimates (27 September 2022); FRP Advisory - Cenkos Securities estimates (22 July 2022); and Begbies Traynor - Shore Capital estimates (22 September 2022)

K3 Capital beats both rivals when it comes to the dividend, offering a prospective dividend yield of 6.1 per cent, or double that of its peers. Given the potential for K3 to recycle its cash pile to make earnings-accretive acquisitions and accelerate earnings growth, and the conservative looking earnings projections for its restructuring unit, it's the stand-out pick amongst sector peers.

Target price

Having taken all the risk factors into consideration, and the potential for a material increase in insolvency work in the next 12 to 18 months as well as the likelihood of further bolt-on acquisitions, the earnings risk appears skewed to the upside: a factor that is not reflected in a sub-sector rating. Furthermore, a hefty free cash flow yield supports projections for another sharp increase in the dividend this year and next, which in turn underpins the prospective dividend yield of 6.1 per cent.

From a technical perspective, the shares appear to have bottomed out at a closing low of 215p in May this year, and successfully retested the price level on two occasions last summer. The 14-day relative strength indicator (RSI) has unwound from an overbought position to a neutral reading of 50 after the share price rallied to an intraday high of 279p at the start of the month following the second retest of the 215p support level. This suggests potential for further recovery in the share price assuming the fundamental case is supportive, as I believe to be the case. A move above the May 2022 high of 295p would narrow the odds of a return to the 350p levels seen at the start of the year.

On a 12-month basis, I have a target price of 340p, or 35 per cent above the current share price, based on a target PE ratio of 14.5 for the 2023/24 financial year. Buy.

Risk assessment

Acquisitions. The board's stated strategy is to grow both organically and through acquisition. There is a risk that acquisitions, joint ventures, or start-up companies are unsuccessful which could have an impact on senior management time, cash reserves, and the group's financial performance. There is a further risk that management fails to identify appropriate acquisition targets or agree terms with such targets.

To mitigate these risks, K3 has appointed an acquisitions director to identify new targets, oversee the due diligence process with third party providers, and to assist with the integration of targets post completion. The structure of all acquisitions is such that shares form a major part of the initial consideration with lock in periods over several years. In addition, earn-out payments are made in a combination of cash and shares with lock-in periods on shares as they are issued. The structure of transactions ties in vendors to the long-term success of the group and discourages anyone wishing to leave in the short-term.

Importantly, the group is well funded to finance the contingent consideration on past acquisitions (£2.4mn due within 12 months and £4.1mn of non-current acquisition-related liabilities). A healthy liquid ratio of 1.6 times indicates that the group has ample resources to trade through any softening of trading and be able to meet its contingent liabilities on past acquisitions.

Credit risk. The group manages its exposure by applying limits to the amount of credit exposure to any one counterparty and employs strict credit worthiness criteria as to the choice of counterparty. The nature of receivable balances, the time taken for payment by clients and the associated credit risk are dependent on the type of engagement. The primary credit risks associated with receivables are:

- On formal insolvency appointments (which form the majority of activities), invoices are generally raised having achieved approval from creditors to draw fees. This is typically settled on a timely basis from case funds. The credit risk on these engagements is considered to be extremely low.
- On transactional activities, invoices are raised on completion of the asset sale or acceptance of a HMRC claim and are typically settled from completion monies or re-claims.
- On other business, the timescale to receive payment from the date of invoice is longer as standard payment terms are not practically enforceable in all situations. The board does not believe that this is an indication of increased credit risk on these engagements.

The group held total receivables of £24.6mn, including unbilled income of £15.5mn and net trade receivables of £8.2mn, at the financial year-end. Around 10 per cent of net trade receivables outstanding were 120 days past their payment date, a segment **worth monitoring as these impairment charges were the major contributor to the £1.3mn charge in the income statement for expected credit losses.**

Economic and political risk. Historically this risk has been managed by diversifying within a sector. The Business Sales division sources clients and buyers from all sectors and industries, across all geographic regions of the UK to spread the risk of downturn in individual markets with revenue derived from a diverse portfolio of clients and sectors. Also, the group issued more than 9,000 invoices last year, so has a relatively small exposure (around £8,000 per invoice) which mitigates customer concentration risk. That said, the Business Sales division is **unlikely to be completely immune from a severe economic downturn and turmoil in financial**

markets that could undermine the ability and willingness of business purchasers to engage in corporate acquisition activity.

Revenue streams have been diversified to counteract the risk associated with economic and political uncertainty by boosting recurring revenue through the acquisitions of Knights R&D and JE Consulting.

Competitive risk. The group operates across M&A, tax and restructuring advisory end-markets, so is exposed to greater competition from existing firms and new entrants.

To try and maintain a competitive advantage, the Business Sales division uses a proprietary technology platform that enables it to target market sales opportunities and uses a network of more than 2,000 accountancy professionals. The tax advisory business has high recurring revenue streams from more than 1,400 clients that typically sign up for three to five years.

Claims risk. In the insolvency practice, Quantuma's professional indemnity insurance is likely to cover the majority of claims made against the business, but there is always the risk that it may be liable for some costs and could suffer from reputational damage.

Key personnel. To mitigate the risk of staff turnover, the group offers competitive remuneration packages and has made significant hires of senior fee earners to enhance sales growth. Chief executive John Rigby and founder Tony Ford have been instrumental in the development of the group, so the **market is likely to react badly if either were to leave**, albeit there is no reason to expect that to happen.

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