Sage Group

SGE

January 21, 2016 FAT-UK-619 | GBP5.50 | Core | MED | B

SGE Snapshot +

Software subscription strength

Sage is one of two UK technology groups in the FTSE 100 and is the UK's largest listed software company. The company provides services to small companies including payroll, accounting and tax software. A shift towards subscription driven revenue has improved the quality of the business and our rating is buy.

We first covered Sage in November 2014 (FAT UK 561) and since then the shares have performed well. The ongoing equity market weakness provides a good opportunity, in our view, to add Sage (£5.8bn market value) to the UK portfolio.

With the company increasingly moving to subscription driven revenue it should be resilient to any ongoing economic weakness. This is in contrast to the previous approach of selling costly software upgrades when there is a product update.

Sage's shift to the cloud: Payrolls, Payments and accounting

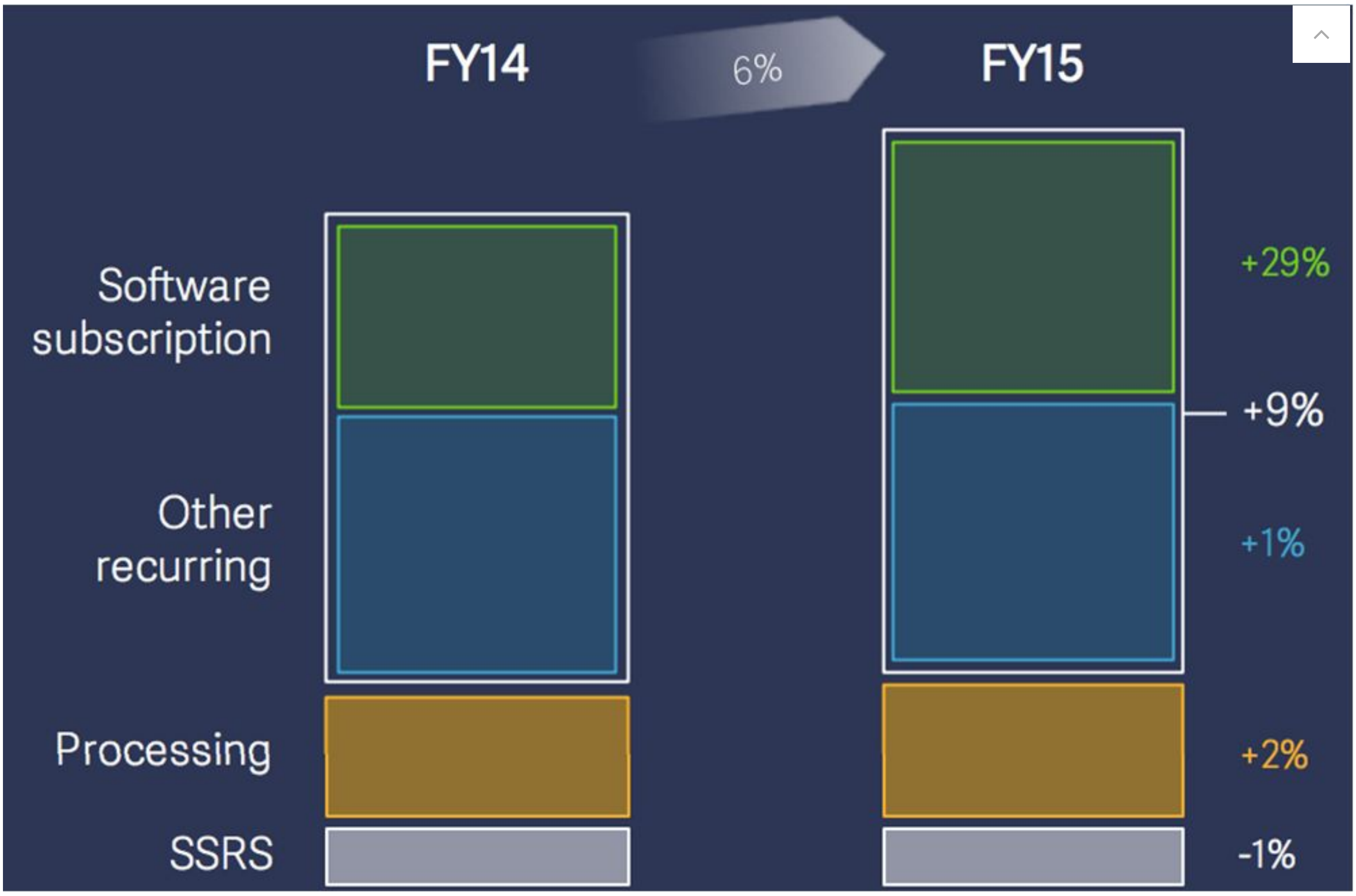
Source: Sage investor presentation

In the year to September 2014 Sage's recurring revenue was 73% of total revenue and in the year to September 2015 it rose to 74.4%. Recurring revenue will continue to become a greater part of group revenue over time.

This shift will help bolster customer loyalty as it doesn't involve a large software purchase which needs to be assessed. Sage is also providing its products through the cloud which helps lower its costs.

In the year to September 2015 the group saw software subscription revenue improve by 29%. This was the main driver behind Sage's overall organic revenue growth at 6%.

Sage subscription software is driving revenue



Source: Sage investor presentation

Looking at the valuation and the stock has re-rated relative to profits over the last few years. The forecast P/E in the year to September 2016 is 20.8X dropping to 19.2X the following year and then 17.5X for the year to September 2018.

While this doesn't appear cheap, the improvement in business quality underpins the valuation and the balance sheet is robust. In the year to September 2019 the forecast P/E is 14.2X with a forecast yield at 3.7% (1.9X covered)

The final dividend for the fiscal year to September 2015 is 8.65p and the shares go ex-dividend on 11th February. For the current year to September 2016 the forecast yield is 2.5% with the payout forecast to be 1.9X covered by profits.

Turning to the technical front, and with reference to the weekly chart, the period from May to December 2015 was characterised by bearish divergence - when prices form a higher high and the RSI forms a lower high. In turn, a sizable correction in price has followed. While

momentum remains favoured towards the downside, we should see support come in betw
532.5p and 537p (the 61.8% Fibonacci retracement from the August 2015 low of 482.90p to the December 2015 high of 625.50p). Should prices respect this zone of support, then we expect a resumption of the longer term uptrend.

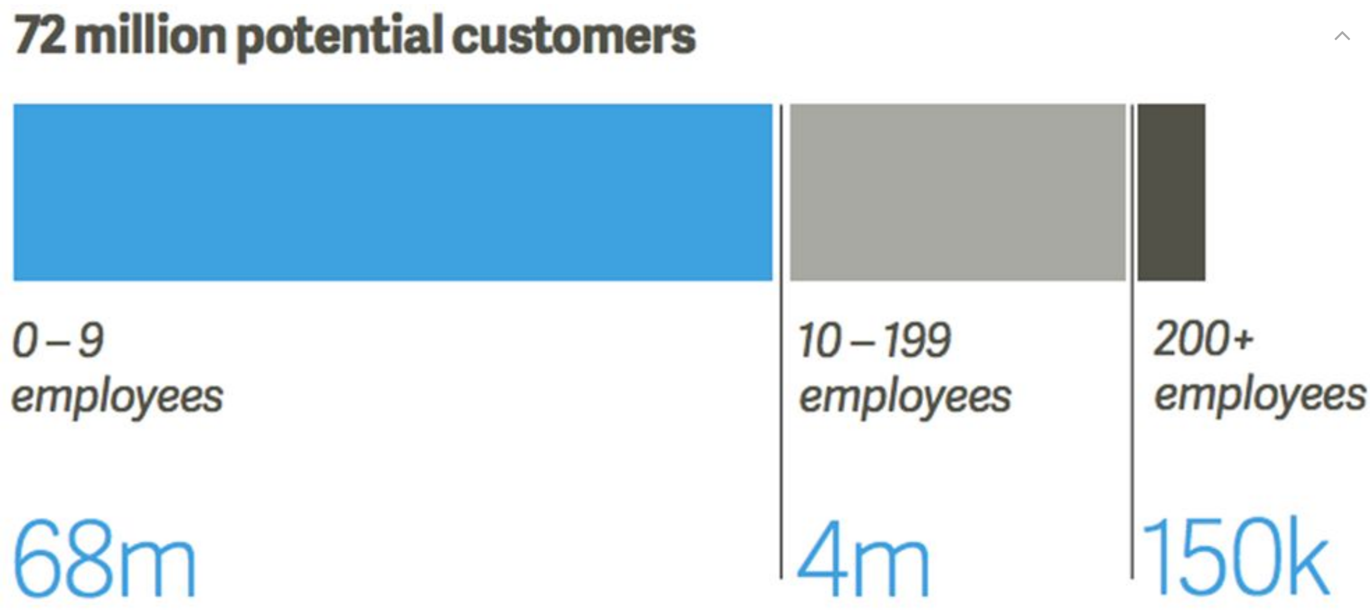
The daily chart shows that despite a 13% correction from the 625.50p high, the bears remain in control. A period of base building at our expected zone of support between 535.5p to 537p is required before buyers emerge. We do though see such an outcome being helped by underlying valuation fundamentals and the current pace of revenue growth.

Sage 101: back-office software for small business

Sage focuses on small and medium sized business, which make up 99% of the world's businesses. In a June 2015 Capital Markets day the group stated that it has 3m customers versus a potential market at 72m businesses.

The internet has driven a shift towards small business given that it reduces the cost of starting up and the overheads. The United States, for example, is seeing 500,000 new business startups every month.

Businesses by employee numbers



Source: Sage annual report

Around half of small businesses who do not use Sage products rely on Excel spreadsheets. This means that Sage doesn't need to dislodge a competitor in this part of the market but only needs to highlight the value of its product suite.

This should be a relatively easy sale given that Excel is time consuming and cumbersome for accounting, payroll and tax functions. A shift towards relatively low cost software helps automate business functions and should save money.

The group also has the potential to cross-sell more products with less than 1.5 products per customer at the moment. Sage Pay is a payment service that the group can sell to its customer base on the back of its existing relationships.

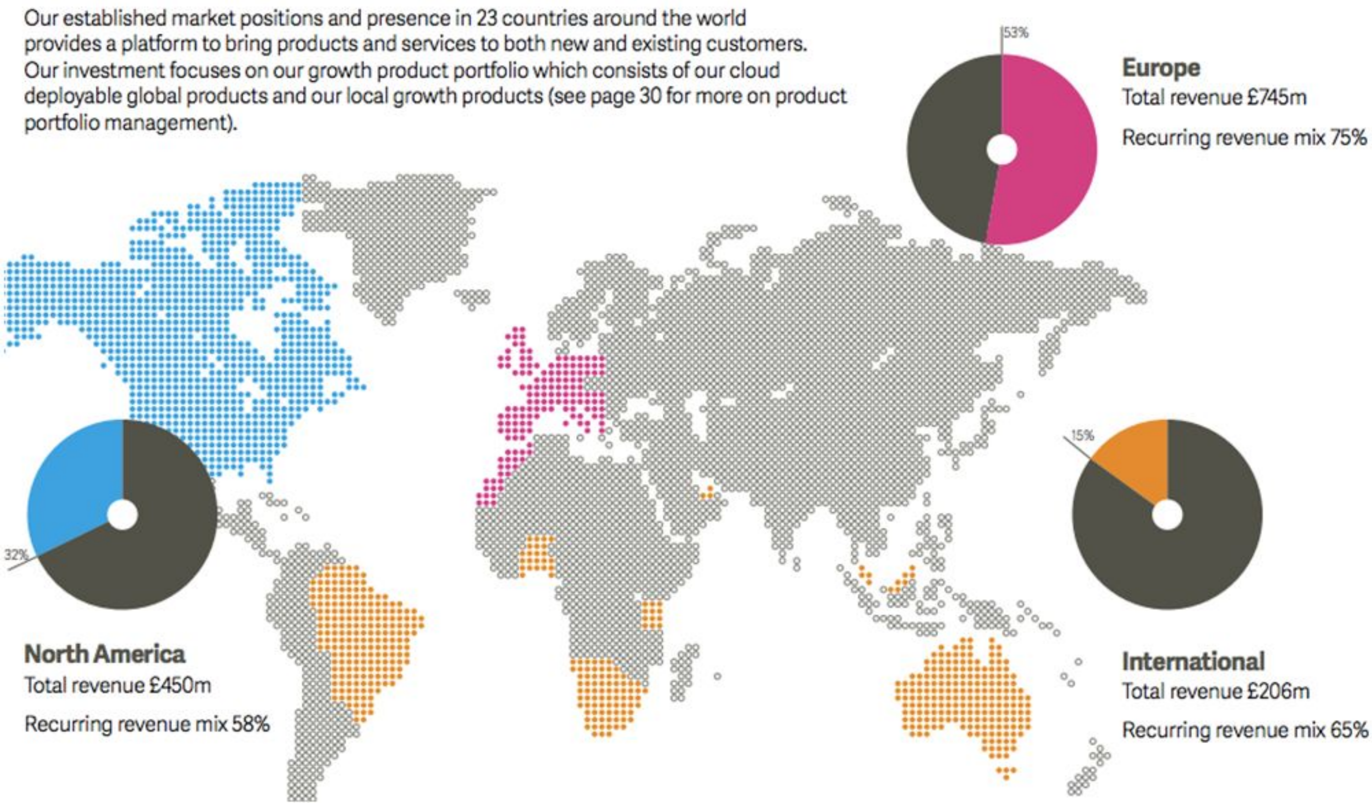
Sage market share and competition

In countries where Sage has a long track record it has achieved a high penetration rate. Over half of UK companies pay their employees using Sage while in Spain 56% of companies pay their taxes using Sage.

The group is the market leader in the UK, Spain, Ireland and France along with Canada and Africa. The group spends £107m on global marketing which is ahead of the global revenue of most of its competitors.

Looking at the group's geographic focus and 53% of organic revenue came from Europe in the year to September 2015. North America generated 32% or organic revenue growth and International markets generated 15%.

Sage's global reach (Year to September 2015)



Source: Sage annual report

In terms of the competition Sage states that there isn't a consistent global competitor. The group's accounting and payroll software, Sage One, was recently released in Australia, Brazil and Malaysia.

Sage's momentum: software subscription

Sage achieved 6% organic revenue growth in the year to September 2015 versus 5% in 2014 and only 2% back in fiscal 2012. The key driver was a 29% increase in software subscription revenue during the year.

The company states in its 2015 annual report that:

"As we continue to transition towards a higher quality revenue model, we have confidence in maintaining our revenue growth by attracting new customers and delivering greater value, functionality and features to our existing customers."

Software subscription contracts increased to 690,000 during the last fiscal year versus 450,000 the year before. In Sage's full year results presentation (year to September 2015) the group boasts that customer renewal rates are up to 84%.

Sage is now spending 87% of its research and development budget on growth products. The group is maintaining the pace of development with research and development 10% of organic revenue last year at £139m.

Sage's outlook

Source: Sage 2015 investor presentation

The outlook is for 6% organic revenue growth and an operating margin of at least 27%. Strong margins and reasonable top-line growth will translate into robust profit growth.

The Cloud: risks and rewards

The shift towards software as a service can be seen around us with e-mail, for example, accessed through web browsers rather than software applications. We are seeing Microsoft moving its Office package into the cloud.

The potential for Sage is to move towards a lower risk and potentially more “sticky” subscription system. At the same time the barriers to entry faced by potential competitors have been reduced.

The evidence to date is that Sage is not losing out given its strong growth in cloud based subscription revenue. Payroll, tax, and HR are critical business functions and so it will be difficult to competitors to make inroads.

Taking the example of customer service and the company offers Sage One customers 24/7 support. This helps cover key areas such as legislative compliance and helps Sage stand out from its peer group.

Financial performance

Sage saw organic revenue improve by 6.7% in the year to September 2015 with recurring revenue up by 8.5%. The operating margin improved by 0.7% to 28.2% and organic operating profit rose by 9.6% to £383m.

Sage results: Financial Year to September

	FY15	FY14	Change
Organic revenue	£1,357m	£1,272m	+6.7%
• Recurring revenue	£1,010m	£930m	+8.5%
• Processing revenue	N/A	N/A	
• SSRS revenue	£348m	£341m	+1.9%
Organic operating profit	£383m	£349m	+9.6%
Organic operating profit margin	28.2%	27.5%	+70bps

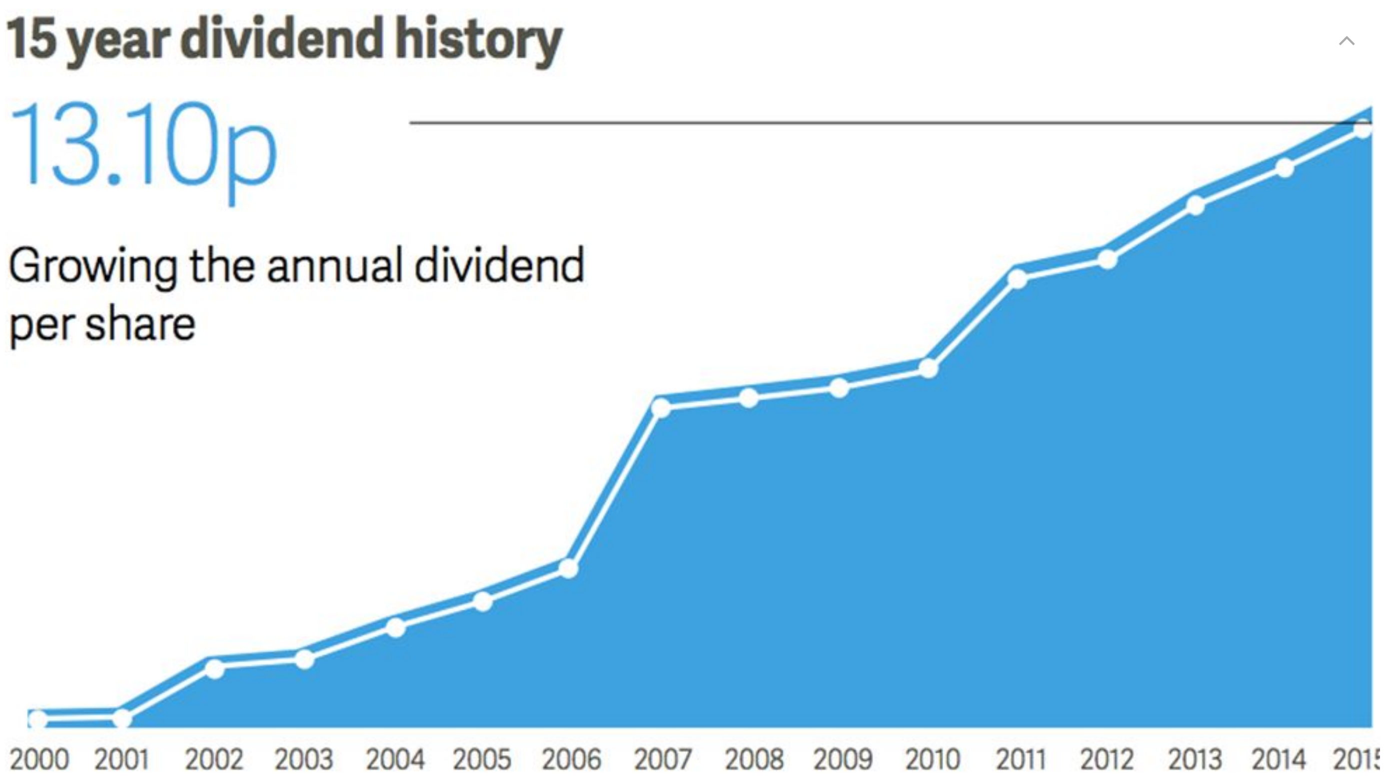
Source: Sage investor presentation

Sage has seen strong freecashflow generation at 20.6% of revenue in 2015 versus 16.9% in 2014. Underlying cash conversion was 106% in 2015 versus 101% in 2014.

The balance sheet is also robust with net debt at £425m at September 2015 which is only 1X rolling 12-month EBITDA. High margins, low debt, strong cash conversion and subscription revenue growth all make for resilient profits.

In terms of the dividend track record and the group joined the FTSE 100 in 1999 and has increased its dividend in every year since then. Sage also paid out a special dividend of 17p in fiscal 2013.

Sage has been a reliable dividend payer



Source: Sage annual report

The most recent dividend for the year to September 2015 at 13.1p was up by 8% on the year before. Dividend cover for the year was 1.91X and the ex-dividend date for the final payment of 8.65p is 11th February.

Summary and valuation

It is fair to say that Sage isn't cheap on near-term valuation metrics with the forecast P/E for the year to September 2016 at 20.8X. However, the pace of revenue growth has been picking up and the business quality is improving.

Strong cash generation also means that Sage offers a forecast dividend yield of 2.5% in the current year. Sage is also less expensive than the similar US business Intuit which is on 26.4X forecast earnings for the year to July 2016.

Given the recurring nature of three-quarter's of Sage's revenue it is worth looking at the valuation further out. In the year to September 2017 the forecast P/E is 19.2X and then in the following year falls to 17.5X.

Earnings growth will be driven by the growth in subscription revenue, selling more products to existing customers and new customer growth. With half of the potential customer base using excel there should be significant potential to continue capturing customers.

In terms of the risk profile and the first issue is that the shift to the cloud creates an increased competitive threat. The second risk is that a downturn will hit small business numbers hard.

On balance the risk/reward ratio appears attractive for Sage, presenting it as a strong core portfolio holding. The company offers significant value to its customers and increasingly generates low risk subscription revenue.

Given current market instability Sage is attractive in that it should offer relatively defensive growth – an attractive combination. Small businesses are likely to continue using Sage's services unless they go out of business.

Accordingly, we recommend Sage as a long-term medium-risk buy to all members.