The Sage Group (Capital Markets Day)
June 24, 2015

Corporate Speakers
- Steve Hare The Sage Group PLC CFO

PRESENTATION

Steve Hare^ Thank you Lisa. Hello everyone and thanks very much.

I also like to say thank you to Alvaro. I'm really pleased to see him here today. When I was going through the interview process for Sage, I met many people. But one of the people I met was Alvaro. And there's probably many of you know, Alvaro sold his business to Sage and has stayed with Sage as he said for 12 years.

And so when I was going through that process, I said to him, Alvaro, why are you still here? What is it that excites you about being in Sage? And he looked at me with his passion and said -- because Steve, I want to be number one. I want to be part of the team that is number one.

But what we're talking to you about today is unique. I think what we're going to show you is unique. Because we've redefined our ambition. We want to be number one.

And we're going to do that by focusing on accelerated quality growth. And we're going to move to a global operating model.

But we are going to continue to support that global operating model by strong connections to the countries. The customer will continue to be served through the countries.

But we need the capability to make global investment decisions. We need to be able to drive and improve return on investment. And we need to create the capability and ability to deploy that additional investment.

In doing this, we're building on the 2012 strategy. But the big difference is we're executing that pace and with precision.

In the medium term, the revenue will -- the revenue growth will start to accelerate and the operating margin will improve. And throughout both the transitional period and also the longer term, we will underpin it with strong free cash flow and increasing dividend.

Now I want to return to talk about ambition. Because our ambition is very simple. We want to be the acknowledged number one in our space and to be the champion of small-medium businesses.

As we deliver on this ambition, we will deliver value to all our stakeholders, because we want to do it the right way. We want to support our customers and their communities. And as we do this, we want to develop -- we want to deliver on our investment case. And there's four key elements to that investment case; sustainable high quality revenue growth, superior margin structure, strong free cash flow, and a progressive dividend.

Now taking each of those in turn, the high quality revenue growth is driven by a shift to recurring revenue. We've talked about this before, but it remains a key feature. A shift to recurring revenue underpinned by subscription.

That would be achieved by both doing that with our existing customers, but also most critically by attracting new customers.

The margin structure -- we will drive efficiency. We will redeploy costs into those areas where we can get a strong return on investment. This is particularly important in terms of switching into digital marketing.

The high quality revenue growth will at all times be supported by strong free cash flow. This is something that all of us feel very passionate about.

Sage has increased its dividend every year since the year 2000 and will continue to do so. So as Stephen already said the board, Stephen and I, the whole management team, we see this as a mission. It's a mission that we are completely committed to.

So let's talk about accelerated quality growth, how do we achieve that? Well it has to start with the most important person, the customer. Our existing customers, we're going to deliver more value to our existing customers. Less of the growth will come from price. Price is important in some economies, but it's important that we drive value and given our customers more so that we have the opportunity to grow together.

But we have this renewed ambition to attract to new customers. We can't be number one unless we attract new customers. And the primary mechanism for this is global products and subscription.

The principle of supporting customers for life is at the heart of what we do. We have a very privileged position with our existing customers, and there's an opportunity for us to growth together as we deliver more value, and as we deliver more productivity to those customers.

We have a range of offerings which are attractive to those customers. And that underpins the sustainable growth that we're committed to during the transitional period of 6%.

Now there's three main ways that we will deliver value to our existing customers. The first is upsell. So this is taking an existing product and delivering more features and functionalities to that product. A good example of us doing that recently is adding the pension auto-enrollment features to Sage 50, and selling that as a feature on subscription.

And we've already sold that to 10% of the payroll customers of Sage 50, generating an additional annualized recurring revenue of GBP7.5 million.

The second way is reactivation. We have a lot of customers who are using the product on perpetual license, but have allowed their maintenance and support contract to lapse. Now this is not about forcing any migration, this is not about forcing people to take something they want. We make it attracting.

Good examples of this, Sage 50 Drive, allowing on-premise products to use Sage 50 Drive to save their documents into the cloud so that they can access to many device. CL in France, same example.

And then the third one is cross-sell. You've heard us talk about cross-sell before, it's not a new one. But in a product-orientated business, it takes a lot of focus to get cross-sell working. And whilst the numbers are small, Stephen referred to the number of Sage Pay, Sage 50 cross-sell customers. In the last five-six months, that number has increased by 70%.

Now we expect the move to subscription to be progressive amongst our existing customers. But driven by enhanced offerings rather than forced migrations. We respect the choice of our customers. We have some fantastic on-premise products which our customers like. We enhanced the mobility aspects of those on-premise products by offering things like Sage Drive and Browser and access to those on-premise products suing hybrid solutions. And for many customers, hybrid may well be the solution that they want for the foreseeable future, and that's fine.

None of these great initiatives are new. But the important message is that we are focused on fixing all the operational issues and barriers that stop this being a success. Focused relentless execution.

So as I've said, if our ambition to be the acknowledged market leader, we need to attract new customers and win market share. Frankly this has not been a focus historically and would require a much different approach. We will need to over-invest, and we're creating customer business centers, the first of which has already been launched in Atlanta, and the second of which we've started -- we've closed on the premises actually last week for Dublin.

The size of the addressable market that we're looking at is very significant. In our existing geographies, there are over 70 million businesses. If you widen that to the geographies we're not in, it's well in excess of 100 million.

Many of these are perfect for Sage One and Sage Life. 99% of all businesses are small and medium size businesses.

For those customers that want something a bit more sophisticated, we have X3, a product which we are going to deploy into our own internal network.

Now I'm going to talk about a few milestones that we're using as targets for our global products internally.

The first one is Sage One. At the half year, we've talked about having 115,000 subscribers globally for Sage One. But we've decided to really raise the ambition. So it might surprise you that our next target is 1 million Sage One customers. 1 million Sage One customers.

So just to give an idea, at the moment, the average revenue for a Sage One customer is GBP5 a month, just under GBP5 a month. So let's say that that stays flat, so those 1 million customers, that would be a GBP60 million business. But actually we aspire to get the average revenue of a contractor. Let's say it goes to GBP7.50 a month, that would be a GBP90 million business.

So you can start to see how that might progress to be something meaningful for the group.

Sage Life -- we think the immediate addressable market for Sage Life is about 4 million businesses. So let's take a 1% market share, let's take 40,000 customers. We're targeting about GBP100 a month, something like that.

Multiple users, everyone faithfully having the application on their mobile phones, so CPUs as like users. So let's take GBP100 a month. So at 40,000 customers, that's nearly GBP50 million of annualized recurring revenue. It doesn't take a lot to extrapolate that up to a number more like GBP200 million at some point in the medium term.

X3, the most established global product. Just over 5,000 customers, but critically over 230,000 users. We estimate that for every 1% increase in market share from what is a relatively low base, that that would drive around GBP45 million of additional revenue. Now that may not be annualized recurring revenue because in the enterprise market, there's still a propensity for perpetual licensing.

But that GBP45 million of additional revenue based on today's turnover could represent about 3% of growth for the group.

So the purpose of these illustrations is just to give you some idea of how global products can start to contribute to great growth. However, the timing of the adoption of these products is uncertain.

So the way to think about it is the installed base, the existing customers, driving a consistent revenue, organic revenue of around 6% in the transitional period. And then as we get into the medium term, the global products will start to kick in and start to drive a higher growth rate.

We've also started to focus the business very clearly on annualized recurring revenue, and also the subset of annualized recurring revenue which is the annualized subscriber base. So two key elements. The overall recurring revenue, but remember nearly half of our revenue today is from maintenance and support. So today, nearly two thirds of that recurring revenue is coming from maintenance and support, and the rest is coming from subscription.

As we drive towards increasing recurring revenue, you'll see a great proportion of that coming from subscription.

And ultimately as we get more recurring revenue, we have more interaction with our customers, we should also see an increase in customer satisfaction.

Now overall, the contract renewal rate is about 84%. Each 1% increase, so going from 84% to 85%, drives about GBP10 million of annualized recurring revenue. Subscription has a higher renewal rate, about 90%. So switching from maintenance and support to subscription automatically drives up the blended renewal rate.

Now I want to talk a bit about investing for growth and what we're doing under the covers so to speak, because we're committing that during the transitional period, we will maintain a 28% operating margin. But underneath the covers of that 28%, there is a lot going on to make Sage more efficient and to create the capacity to invest for growth.

Two elements to that -- the global operating model, and investment allocation.

So let's start with the global operating model. As always, it starts with the customer. As I've already said, the customer remains the responsibility of the country managing director. You heard Liz say how much time she's spending with customers. It's critical that we enable our country managing directors to spend time with customers, to spend time out in the community representing small and medium sized businesses, whilst people like me water the plants.

Historically Sage has operated through a decentralized country model which has led to a lot of duplication. Now we're going to migrate to this global model now, which every other global technology company operates.

And key to that is the linkage between product development, technology, marketing and linking all of that into the country. So making global decisions, but connected to the country, making sure that it remains connected to the customers.

The support functions will also be run globally, Stephen mentioned this. This is already happened. They will be targeted to improve both service and also efficiency. Things like transactional processing cost will come down, numbers of systems, processes, all that duplication will be reduced. We're going to implement the Salesforce customer relationship management tool. And as already said, we're going to use X3 as our general ledger.

So we have a lot going on. I'm not going to give a detailed commentary about every single aspect of it. But we have got work streams in place. And you'd be able to see evidence of the progress through the KPIs when we do the full year and half year results while we also give a bit more color and a bit more context.

We're going to be reinvesting any savings during the transitional period, hence maintaining the 28% operating margin. And as Stephen has said, just one word of warning, this is not going to be a perfect quarter by quarter journey. And maybe a few bumps in the road. But the important thing is the trajectory.

Now ultimately, all of this change is focused on improving efficiency, but ultimately creating an exceptional customer experience, because that in turn drives retention and supports the customer for life strategy.

Now on investment allocation -- to invest for growth, how we allocate our investment particularly across marketing, service, sales and product development is critical. And we must make these allocations on a more global basis.

There's no point in each country making its own individual decision. We need to be allocating our resources on a global basis.

Now central to this is product prioritization. So in the past, we've had these three categories; invest, sunset, and the harvest. We're going to reduce those to two; growth and heritage.

Growth products will include global products and also the key local on-premise products. Each country will probably have one category of each product. So a country will have one accounting product, one payroll product, one payments product as appropriate. So an integrated suite of offerings to the customer.

A great product is one in which we will continue to invest, enhance functionality, and continue to sell to our existing and also our new customers.

The primary product set which we will use to attract new customers is the global product set. However, we will also sell existing on-premise products to new customers if that's what they require. If a new customer wants to buy Sage 50, we will sell them Sage 50.

The commercial proposition of growth products will be driven more by global product marketing, again connected to the countries, but we're going to have greater consistency in terms of how we go to market with our global product set.

Whilst there may be more than this initially, the target is that we'll have about 50 growth products, and they will represent over three quarters of global revenue.

All of the products will be heritage products. So a heritage product is one where there will be very little sales and marketing, because we're not marketing the product, we're not selling the product. The R&D will be limited to minor enhancements, bug fixes, compliance upgrades, et cetera. As well as building migration tools so that when customers are ready to migrate, we have the ability to do so.

But just to be clear in case there's any misunderstanding, we will not end of life products. As long as a customer is on a support contract and paying an economic rate for that contract, we will not end of life products.

Now looking forward, there's four things I just want to touch on; revenue mix, the outlook for revenue -- for growth and margin, the cost base and cash generation and how we use that cash.

Two phases, I've already referred to them; transitional, medium term.

Throughout the transitional period, annualized recurring revenue will grow. So whilst we're talking about a 6% overall growth rate, annualized recurring revenue and therefore recurring revenue will grow faster than that. Because SSRS, one of perpetual licenses in particular will decline to have a blend of 6%.

We're also going to see a shift from maintenance and support into bundled offerings of subscription. So there will also be a mixed change within that recurring revenue.

Now the target on recurring revenue is to get to around 85% to 90% of total revenue being recurring. We'll unlikely to get higher than 90% for the foreseeable future because of the propensity for enterprise customers to still want to buy perpetual licenses. So 85% to 90%.

Beyond the medium -- beyond the transitional period as I've said, you can expect to see that 6% headline revenue growth therefore start to increase as the SSRS flattens out. Likewise throughout the transitional period, we'll maintain the operating margin of 28%, albeit as I've said lot of action taking place underneath the covers. And then in the medium term as the need to overinvest starts to drop, the margin will also increase.

So let's just take a little look at the cost structure. It starts with sales and marketing.

Sales and marketing is going to intend to increase over time as a percentage of revenue as we start to really invest for growth and target new customers.

Support, likely to be pretty flat, because we remain committed to providing high quality customer support. We like the fact that somebody when they sat at their dining room table at midnight and they want to speak to someone because they can't figure something out, they can call Sage. And we're committed to offering that service.

R&D is likely to run at about 10% to 12%, but with a much tighter focus on growth products and also shorter cycles to market. You're going to see things like Sage Life, but also new feature sets, more rapid deployment to market that you've seen in the past on Sage.

On G&A, the run rate of G&A as Stephen said including facilities and IT is 22%. This is clearly high. And will come down as the duplication is reduced, and as we drive efficiency. And a number of these actions have already started.

If would be inappropriate for me to go into details today, however there will be a cost to this change, and anything that we do will have a payback better than two years. But we'll give a more complete update at the full year results.

On cash flow, the strong cash generation is very important to us. We continue to target free cash flow as a percentage of revenue in this 15% to 20% range.

Our aim is to maintain strong operating cash flow conversion during this transitional period, and we will remain very disciplined on capital expenditure.

We are likely to do some acquisitions. However, the acquisitions we do do will be integrated, we won't buy things and just leave them standalone. And we don't fell under any particular pressure today because there are no obvious gaps.

It's also worth noting that in the past to achieve geographical expansion, we would've gone out [in quiet]. Now, we may do that in the appropriate circumstances, but using customer business centers and using digital marketing and frictionless selling, we can now enter new territories using our digital capabilities. So it's not necessarily the case that every time we look to do geographical expansion, that we will acquire.

We're also committed to increasing our dividend every year, and we're also committed to our one times net debt to EBITDA leverage target, but with the flexibility if we do cash acquisitions to move to around two.

Now we've refreshed the KPIs. I've mentioned a number of times the organic revenue growth of 6 and the 28% operating margin. But they're underpins. They're the table stakes. So how do you measure those? What are the leading indicators?

For attracting new customers, it's global product customer numbers. Look at how many subscriptions we have for Sage. One, look at the rates of adoption for Sage Life, and look at the number of customers and users for X3.

For the quality of revenue and the shift to recurring revenue, annualized recurring revenue is the key, as is the annualized subscriber base. I would expect that soon, we will get to double digit annualized recurring revenue.

For customer for life, it's the renewal rate. Watch the renewal rates and watch that take up, although it would be progressive, driven largely by great retention and the switch to subscription.

And during the transition process, it will be important to see how we redeploy our cost base so we will give updates in terms of how we are moving in terms of moving cost from G&A to sales and marketing.

This will obviously complement our existing financial KPIs, all of which we will continue to report.

So as to summarize, we've redefined our ambition. We know what we need to. It's about execution. We believe we can deliver around 6% organic revenue growth throughout the transitional period, whilst increasing the quality of that growth.

We believe we can attract new customers. But the timing is more uncertain for that.

We believe we can deliver at least a 28% operating margin underpinned by strong free cash flow. But there is a lot to do. And as I've said, not every quarter will necessarily be perfect.

But in the medium term, Sage is going to be a very, very different business. Sage will have sustainable, high quality revenue growth, 85% to 90% of which will be recurring. We will have an efficient cost structure, which will drive a higher operating margin than we have today.

We will continue to have class-leading free cash flow generation.

And to complete the picture for investors, we will continue every year to increase the dividend.

So I appreciate the opportunity today to describe with picture to you, which is I said at the beginning I think it's unique.

And what I'd now like to do is Stephen and I would just like to give you some taster in terms of what you can expect after the coffee to make sure you all come back.