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Full Year 2018 Sage Group PLC Earnings Call

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PRESENTATION

Donald H. Brydon ***The Sage Group plc - Chairman***

Good morning, everyone. My name is Donald Brydon. I'm Chairman of Sage. And I'm delighted to welcome you to this results presentation this morning. I'm standing here to introduce Steve Hare, our new CEO, but of course, I understand that many of you know him very well already.

As we expected, Steve has hit the ground running and is delivering considerable momentum inside the company in his first few weeks. He has communicated with great clarity and simplicity that he is building the sustainable processes that will underlie the development of Sage to be a great SaaS business. He's already empowered his management team, brought SaaS firmly to the table by adding to his Executive Committee, sent strong and positive messages throughout the company and made some significant decisions, which the board has given him total backing for very quickly in his tenure.

So without further ado, let me introduce Steve to you to take you through the results.

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

Thank you, Donald. I'd like to extend my welcome to everyone in the room to the Sage FY '18 results presentation and also to everyone on the phone and on the webcast. And I have to say I'm absolutely delighted to be stood here as the Chief Executive of Sage. And I'd like to start by introducing Derk Bleeker. Derk is the Head of Corporate Development and Commercial Finance for Sage. He's been with Sage for 4 years, having joined originally to head up the corporate development team, and Derk was instrumental in the acquisitions of Sage Intacct and Sage People as well as the disposal of the North American Payments business. And Derk is going to be presenting the financial review today.

I also want to take the opportunity just to point out a few members of the executive team who are here in the audience today, starting with Keith Robinson. Many of you will remember Keith from the Capital Markets Day. Keith is now the Chief Strategy Officer for Sage and acts as an adviser to the Executive Committee. And Keith has a wealth of SaaS and technology experience, having worked in the industry for most of his career both actually as an operator and also as an investor.

I'd also like to introduce you to Sabby Gill, who is the Managing Director of the U.K. business and Northern Europe. Sabby joined us in September, joined us from Epicor, and again spent a 30-year career in technology. And we're delighted to have Sabby running our Northern European business.

Sarah Rolls is also here in the audience. Sarah is the EVP of Financial Control and Operations. And of particular note is Sarah is our IFRS 15 expert. So any queries you have at the end, Sarah is here to help you. And Sarah recently joined us, having previously been a partner in KPMG.

And then the final thing and just as a reminder, one of my early decisions was to add Rob Reid, who's the EVP of Sage Intacct, to the Executive Committee. And the reason I did that is that Rob has a wealth of experience of taking businesses to the cloud and being involved in SaaS businesses. And he's also based in the U.S., based in California. So I think having, again, that insight around the leadership table has been extremely helpful.

And so before I sort of get into the agenda, as usual, safe harbor notice, which is behind me on the screen and is also in your packs. So if we go to the agenda, I'm going hand over in a moment to Derk to go through the financial review. And then I'm going to come back and talk a bit about strategy and outlook, both FY '19 and also a little bit beyond that.

But before I hand over to Derk, I just want to introduce and emphasize the vision. The vision is very clear: it's to become a great SaaS business for customers and colleagues alike. Now one of my key reflections is that Sage has been trying to do too much all at the same time. And so you'll hear a lot from me this morning about focus. And that focus will be centered around 3 things: customer success, colleague success and innovation. And so I'll talk about each one of those a lot more when I come back.

But for now, I'm going to ask Derk to go through the financial review.

Derk Bleeker

Thank you, Steve, for the introduction. And like Steve, I'd like to welcome you all to today's results presentation. I'm very pleased to have the opportunity to present you with additional color on the full year performance for FY '18.

Now to start, let me take you through the 3 key messages I'd like you all to take away from this presentation today in relation to FY '18. One, there is no denying that FY '18 overall was a challenging year. We met our revised guidance, but to be clear, we do not feel that these results reflect our potential. Two, our free cash flow margin and our balance sheet continue to be core strengths, and we have practically delevered the GBP 1 billion of acquisitions in '17, at the same time as increasing the dividend and continuing to transition the business to subscription. Three, we exited FY '18 with real momentum, in particular on recurring revenue growth. Focusing the business in H2 on executing to the key priorities to drive subscription and recurring growth has had a real impact. Although it is early days, we continue to see this momentum in FY '19 Q1 with a strong October.

And before taking you through our results, I want to provide you with a quick reminder of some of the terminology used in our reporting. Our organic revenue definition is at constant exchange rates and excludes the contribution from current period acquisitions, discontinued operations, disposals and assets held for sale. However, prior period acquisitions, such as Sage Intacct and Sage People, are included in both FY '17 and FY '18 organic results.

We have today announced that we hold for sale Sage Payroll Solutions, our U.S. payroll outsourcing business, representing revenue of GBP 38 million with operating losses of GBP 1 million. Sage Payroll Solutions is being actively marketed, and we expect to exit the business during FY '19. Steve will provide a bit more context on this planned divestiture later in his presentation.

Our guidance was to an organic revenue growth of around 7%. On that basis, our revenue growth in FY '18 was 6.8%. Including Sage Payroll Solutions, which was the business that's constituted at the time of guidance, growth was 6.6%. Please note that the deferred revenue adjustment for Intacct, which is the unwind of the deferred revenue haircut resulting from the acquisition accounting, was GBP 11 million, and our revenue growth was 7.6% on a statutory basis. Recurring revenue growth for FY '18 was 6.7%, with a significant sequential acceleration in H2 over H1, resulting in recurring revenues for September well above 7% up on the same month in FY '17.

Turning now to margins. FY '18 operating profit is presented on the same basis as organic revenue, so it excludes Sage Payroll Solutions from the current period. Underlying operating profit as presented includes Sage Payroll Solutions. Our guidance was to an organic operating profit margin of around 27.5%. And on that basis, our operating profit margin in FY '18 was 27.8%. On an underlying basis, including Sage Payroll Solutions, our operating profit margin was 27.2%.

As you can see, our EBITDA margins remained strong at 29.2%. And adjusted EPS, which includes the pro forma adjustments to FY '17 for Sage People and Sage Intacct and North American Payments disposal, grew in excess of 14%.

You will note our operating profit margins exclude a nonrecurring charge of GBP 10 million, of which GBP 9 million related to provisions for exceptional legal claims and structural redundancies.

And finally, a quick note on tax, which is not covered in the slide. Our effective tax rate was 26%, in line with our expectations. We expect to continue to maintain an effective tax rate in the range of 25% to 27% in the medium term.

Now this next slide bridges the reported organic operating margin in FY '17, which therefore excludes Sage People, Sage Intacct and our U.S. Payments business to the reported FY '18 underlying and organic operating profit margins. As you can see, applying the dilutive impact of Sage People and Sage Intacct on our reported FY '17 organic operating margin, on a pro forma basis, we increased margins by 1.3% in FY '18 from 25.8% to 27.2%, rising to 27.8% when Sage Payroll Solutions is excluded. In other words, excluding Sage People and Sage Intacct, our organic operating margin would be over 30% today.

What I would like you to take away from this slide is the following. First of all, that we delivered what we said at the time of the acquisition, and we are funding the margin dilution from efficiency savings. Second, even as we look to accelerate investment in FY '19, as Steve will set out later, we remain committed to continuing to drive efficiency to fund growth.

So let's move now to the key cash flow metrics. Our free cash flow as a percentage of revenue is 19%, which is at the upper end of our guided range of 15% to 20%. This was driven by a solid 96% underlying cash flow conversion. Our net debt-to-EBITDA ratio declined to 1.2x from 1.6x last year and is well within our guided range. Our ROCE remained strong at 23%, the change in year-on-year driven purely by the inclusion of Sage People and Sage Intacct and the average capital employed definition for the full period.

In summary, we remain a highly cash-generative business, and our ongoing drive to subscription as a business model, we expect will continue to underpin strong and predictable cash flow dynamics in the business going forward. In the meantime, we've almost fully delevered the acquisition of Sage Intacct and Sage People, even whilst continuing to increase dividends, which will be up 7% this year to 16.5p and continuing to transition the business to subscription.

Now let's dive in a little deeper on the components of revenue performance in FY '18. As you can see on the slide, software subscription penetration increased to 46%, up 7% from prior year. This is the result of our continued drive to the Sage Business Cloud on subscription. It also shows the significant remaining potential to deliver enhanced value to existing customers on cloud and subscription.

Recurring revenue growth of 6.7% was composed of 25% growth in subscription, mirrored by a 12% decline in maintenance and support revenue. SSRS revenue grew 8%, driven by performance in Enterprise Management, in particular in North America and France, which in FY '18 was still largely perpetual and maintenance business. SSRS was also bolstered by strong growth in services. Now as Steve will set out later, we do not expect to sustain this level of SSRS growth going forward as we increase our focus on driving subscription. Excluding Sage Payroll Solutions, processing revenue is now only just over 3% of our total revenue and grew 6% in FY '18.

So let's dive in briefly on the Sage Business Cloud metrics. Our cloud-connected ARR growth in FY '18 was 66%, which is good progress from H1. This was driven by significant momentum in cloud connected in North America, Northern Europe and France, which I'll come back to in a moment. Today, we have 270,000 cloud-connected contracts, with 1/3 of Sage 50 customers now in the cloud-connected solution. There remains very significant opportunity for further migration and reactivation of Sage 50 and Sage 200 customers in the coming years. We will also be expanding the scope of cloud connected during FY '19, adding more products and categories, for example, payroll and HR, to drive the next wave of cloud-connected growth.

Now turning to the cloud-native part of the Sage Business Cloud. Our cloud-native ARR grew at 30%, mainly driven by Sage Intacct and Sage People, which delivered ARR growth of 30% and 49%, respectively. Both businesses hit record new customer acquisition and remain underpinned by market-leading value renewal rates of 108% and 110%, respectively. Sage Accounting ARR growth of 18% reflects a focus on improving the unit economics, driving higher-quality revenue and lower churn whilst investing to enhance the experience for accountants.

Coming back to total recurring revenue for a moment. As I explained earlier, we have seen a significant change in the momentum of recurring revenue growth in H2, with well above 7% recurring revenue growth September '18 on September '17. Similarly, we have seen a significant acceleration in sequential revenue growth in H2 over H1 and in Q4 over Q3. Now this change in momentum in H2 is really the result of significant improvements in focus, clarity and execution around the strategic imperative of driving a financial and operating business model focused unambiguously on recurring revenue, which is what ultimately drives shareholder value in the software business. Much work has been done in the last few months to realign the organization to that objective, from the way that we built our plans and our budgets, the design of our operating model and systems, the way we measure and review through to how we incentivize our people. The early signs, as I've said, are promising, with strong growth in October and particularly good momentum on recurring and subscription in October.

Before we dive into regional performance, I'd like to take a step back and reflect on where we were -- where we are, rather, in our journey from a financial point of view. Now back in FY '14, as you'll see on the slide, Sage reported revenues of GBP 1.3 billion, of which 65% was recurring revenue by today's definition and only 16%, GBP 200 million, was software subscription. Today, we report over GBP 1.8 billion revenue, just under 80% recurring and 46%, nearly GBP 850 million, software subscription revenues. This is what we have been driving and investing in for the last 4 years, and it represents a huge transformation in the quality of our revenue.

As we set out on Capital Markets Day, our strategy is to be an 85% to 90% recurring revenue business, 100% on subscription. Once we have a way ahead of us, our progress to date shows that this kind of transformative change is very much possible.

So let's move on to regional performance. As North America, Northern Europe and France make up 2/3 of our total revenue, I will review these regions individually in more detail.

So let's start with our biggest region, North America, which represents 30% of our revenue. As you can see on the slide behind me, software subscription penetration went up to 48%. If you consider that in FY '16, software subscription was just 14% of revenue, it is no overstatement to say that our North American business has been radically transformed in the last 2 years. This transformation is clearly visible in the results, with North America posting 12% organic revenue growth and 13% recurring revenue growth. Even excluding Sage Intacct, the region still grew recurring revenue at over 10% this year. Success in the U.S., excluding Intacct, was driven by cloud-connected solutions, with well over half of on-premise customers on 50 and 200 now on the Sage Business Cloud. This resulted in an 82% increase in cloud-connected revenue for the year. In Canada, which, just as a reminder, is a business roughly the same size as Intacct today, we saw the second year in a row of double-digit recurring revenue and organic revenue growth. In fact, Canadian recurring revenue growth has exceeded 14% for 2 years in a row. Enterprise Management performance in North America continued to be strong, with growth of 25%, with Canadian Enterprise Management revenues more than doubling in the year. Sage People grew by nearly 50% in the region with the successful launch in Canada. Intacct shows continued momentum with ARR growth of 30%, fueled by strong new customer acquisition as well as 108% renewal by value.

So what will we focus on in North America in FY '19? First of all, to continue the momentum on cloud connected. There remains significant runway for our 200 cloud-connected family in particular. Secondly, driving continued growth in Enterprise Management and accelerated growth in Sage People in the U.S. Finally, ensuring continued momentum at Sage Intacct. As well as taking Sage Intacct international, which Steve will come back to later, we remain focused on the immense opportunity presented by the North American market for this business.

Turning next to Northern Europe, a region which represents over 20% of our revenue. As you can see on the slide, here, too, we made significant progress in our transition to subscription, with subscription software penetration rising to 47% for the year and reaching 50% by Q4. Growth of 2% for the full year does not reflect the significant progress made in H2, where the business refocused on driving subscription, which resulted in adding 5x as many 50cloud contracts in H2 as it did in H1, taking over half our Sage 50 customers to cloud connected on subscription and reactivating over 10,000 contracts in the process. This drove significant acceleration in H2, with recurring revenue growing 6% sequentially, H2 to H1, compared to a 2% sequential decline in H1 as a result of the issues discussed at the H1 results.

In FY '19, Northern Europe will be focused on pushing forward with the migration of 50cloud and launching 200cloud, cementing Sage People's position as a leader in the market of cloud HCM and preparing for the launch of Sage Intacct in the U.K.

Now to France, which represents over 15% of our group revenue. As you can see, software subscription penetration approached 60% in the year. The expected improvement to performance for H2, which we highlighted at the H1 results, materialized, with H2 growth of 6%, up significantly from 1% for both H1 and FY '17, resulting in full year growth of 3%. Cloud connected represented over 15% of recurring revenue by September '18 compared to 4% in the same month the previous year, with Sage 50cloud and Sage 200cloud each growing triple digit.

France represents almost half of our global revenue for Enterprise Management. And this business continues to grow at 12% in FY '18. In FY '19, the focus will be on driving cloud connected, accelerating growth in Enterprise Management and launching Sage People.

Now let's move to the rest of Europe. During FY '18, this region has continued to be focused primarily on organic revenue growth as we phased in the cloud-connected products during the course of the year. As you can see in the slide behind me, they delivered a solid performance on that basis, with organic revenue growth of 9%, partly driven by strong SSRS growth from services related to various legislative changes. Within that, the 2 largest countries, Germany and Spain, grew at 10% and 8%, respectively. Some of the smaller countries showed great momentum, for example, Portugal growing at 17% and Poland at 11%. In FY '19, these regions will focus fully on accelerating their subscription and recurring revenue growth in the Sage Business Cloud.

Finally, let's quickly review our international region. Overall revenue growth of 5% was muted by subpar SSRS performance in Africa and Middle East, mainly related to Enterprise Management execution issues discussed in H1 and low growth in Brazil. Now here, we have seen significant recovery with H2 growth of 8%. Australia continues to perform strongly, growing double digits, led by Sage 50 and payroll, with great success also here for Sage People. In FY '19, we will focus on sustaining the improvements in Enterprise Management execution in the Africa and Middle East region, accelerating subscription growth in Brazil and launching Sage Intacct in Australia.

So now I'm going to walk you briefly through the impact of IFRS 15 on our numbers, which will be applied for FY '19 reporting. As set out in the notes to our financial statements, the IFRS 15 adjustments relate to unbundling of certain on-premise contracts, the amortization of contract sign-on fees, the treatment of commissions and the treatment of certain business partner contracts. We will not restate our historical income statements on a GAAP/IFRS 15 basis. We have, however, applied our IFRS 15 methodology to our FY '18 revenue on a pro forma basis to allow us to report growth numbers on a like-for-like basis. On this pro forma basis, FY '18 organic revenue would be GBP 10 million lower than reported and recurring revenue GBP 3 million lower. Our FY '19 guidance revenue growth targets, which Steve will cover in his presentation, are calculated from this revised base. We do not expect IFRS 15 to have a material impact on the like-for-like growth rates in FY '19 or on FY '19 margins.

Now finally, again, on the slide behind me, a quick reminder of the 3 key takeaways in relation to FY '18.

Now before closing on FY '18 and handing to Steve to set out our vision and strategy for FY '19 and beyond, I wanted to give you a very brief perspective of my own on what this accelerated transition to SaaS really means and why it is the right path to creating shareholder value. During my time leading corporate development, I reviewed diligence and spent time with management of many high-quality and high-growth SaaS businesses. We also acquired some world-class businesses like Sage Intacct and Sage People.

In my experience, the key shared elements of DNA of every successful SaaS business are twofold. First, a relentless focus on those elements of the business that drive a great customer experience, which in turn drives subscription revenue growth through high-value retention and drives efficient customer acquisition. Second, complete coherence between how every part of the organization works: the people, the system, the product, support, financial reporting, everything, everything and everyone focused on and built around the customer.

The real challenge in transitioning to a SaaS model then is not just the components, installing a new CRM system or moving the pricing model to subscription. These are very important but ultimately not sufficient. The real challenge is in moving all of the components of the operating model, including and most importantly the culture at the same time and in the same direction. In the last few years, we have made huge progress at moving some of the key individual parts of subscription growth. And as Steve will set out later, in FY '19, we are looking to accelerate the progress we have made in H2 on sharpening our focus and improving the alignment and coherence in order to build that world-class, high-growth and highly efficient SaaS business. This isn't an overnight change, but the prize, without any doubt, is worth the hard work and patience.

The mathematics of a SaaS business model are both simple and compelling. You drive the subscription model with a relentless focus on the customer, improving retention to expand customer lifetime value, which is ultimately shareholder value, factor in the opportunities for up- and cross-sell in the SaaS customer relationship, improve the efficiency of acquiring customers, and when you put it together, customer lifetime value increases not just incrementally but exponentially. And this is what in turn drives an exponentially increasing shareholder value. This is why SAP paid 20x revenue for Qualtrics last week, why Adobe paid 15x revenue for Marketo, Workday 14x revenue for Adaptive and why we paid 10x revenue for Sage Intacct back in '17. Now to be clear, I'm not suggesting that Sage today should be valued at these revenue multiples. I'm simply illustrating the potential prize available to us from investing to drive forward with our SaaS transition and focusing on accelerating recurring revenue growth.

As Steve will set out later today, we have GBP 1.5 billion of revenue from customers, for who we see a clear path to SaaS in the Sage Business Cloud. What a fantastic opportunity. All that stands between us and the prize is judicious investment, as Steve will set out for you in a moment, and execution.

Now with that, I'll now pass back to Steve, who will take you through what we're going to do to deliver that prize in FY '19 and beyond.

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

So thanks, Derk. And so good context on the FY '18 results and some really insightful views into some of the characteristics of the SaaS business and why it's so important for Sage.

Now as I said earlier, the vision is for us to become a great SaaS business for customers and colleagues alike. And Derk talked about some of what the end prize looks like, but also some of what's required to get there. But it's worth just reflecting, we have made a lot of progress on this journey over the last few years, and in fact, we already have a pretty good SaaS business. We have 79% of our revenue coming from recurring. We have 46% of our revenue already on software subscription. Sage Business Cloud ARR is GBP 434 million and grew last year at 50%. But in FY '18, we did not make the progress that we wanted to. And since I took on the role of interim COO at the end of August and more recently COO -- CEO, I've been reflecting and having conversations with colleagues, with customers, with partners, with investors as well as doing my own analysis and reflections. And this is what I've concluded: it starts with the fact that we've been trying to do too much all at the same time, and we haven't been as effective as we should have been at making choices about where to focus. But also, we need to keep things really simple. Complexity creates confusion and inconsistency. Focus and coherence together are the key to effective and consistent execution.

So what do I believe the solution is? Well, first of all, I have huge confidence that we are going to become a great SaaS business. But to do this, we need to accelerate investment. And we do need to really sharpen our focus on 3 key areas: customer success, colleague success and innovation. Now the good news is these are 3 areas which we're already good at. And I really intend to play to our strengths. These 3 areas are essentially the cornerstone of our strategy. And if you combine this with the increased investment of GBP 60 million, which is -- this is where the GBP 60 million is going, it's going in these 3 areas, and you combine that together, that is our case for growth.

And I'm just going to spend a little bit of time now on each one of these elements. So I'm going to start with the customer, with customer success, and what that looks like in a SaaS business. Well, first of all, it starts with your existing customers, by helping them to become more successful, providing them with solutions that make their lives easier and freeing up their time whilst always keeping them safe. Because this relationship is built on trust. It's also built on a 2-way dialogue where we constantly engage with our customers, and we listen to them and provide them with the service and experience that they're looking for.

So that brings me to the assessment. Where are we? Where do I think we are today? Well, I want to start by saying, ever since Sage was founded, customer service has always been seen as a priority. Now our Trustpilot rating in the U.K. of 8.4 is good. It's one of the highest in the industry. And our customer services team, we've always seen them as a major competitive differentiator. And last year, we had over 9 million interactions with our customers.

We also have a very wide range of customers. We have a small -- from a small business who issued their first invoice with Sage right up to companies who are deploying Enterprise Management across multiple countries. But the theme is the same: our strength is the relationships and the way we support our customers. However, at the moment, a lot of that interaction is of a more transactional nature. A customer calls us, we try and help solve the problem for them. We call them, we try to sell them something rather than the continuous relationship that really great SaaS businesses create. And also, our customer information in too many instances is held in different databases. And what this means is that the customer gets an inconsistent experience depending on who they're speaking to.

So how do we achieve excellence? To support a true customer success model, we have to invest more and faster in the tools and systems that create that enhanced experience for our customers. And that has to start with accelerating the implementation of a single CRM system so that all of our colleagues have a single view of the customer. And then they can provide a much more personalized bespoke experience based around the customers' needs. It also means investing in best-in-class cloud software and customer services that allows the teams to increase and enhance the level of efficient interaction with a consistent experience, again, across digital, web chat, artificial intelligence or phone.

Now what these investments allow is for our sales and services colleagues to then deliver a seamless and continuous experience to our customers, which both accelerate the quality of the interaction but obviously also the opportunity to offer more value. Now both Sage Intacct and Sage People already have best-in-class customer success models. And the best evidence of that is their value renewal rates, which are 108% and 110%, respectively. Now we intend to leverage this across Sage so that we can improve our overall group renewal rate, which is currently around 100%.

Now work has already started in this area in FY '18, so it's not new. We have made good progress from improving the digital interactions across forums, webinars, et cetera, whether topics like GDPR, MTD, to piloting customer success training and tools. But in FY '19, I intend to accelerate this by going faster.

So what about colleagues? Now I said I was going to play to our strengths, and perhaps the most obvious example of this is when I talk about our people. Sage has around 13,000 colleagues around the world, and what unites them is they care. They care about customers, they care about each other, and they care about Sage. I actually want to take this opportunity to thank them for all their hard work and dedication particularly this year, but we need to do more to support them to succeed and really make them feel valued. Great SaaS companies create a culture which fosters collaboration, open honest dialogue and where colleagues feel really connected to the vision.

Now of course, the 2 areas of customers and colleagues are completely intertwined. It's impossible to have happy, successful customers if you don't have happy, engaged colleagues. The good news, though, is we start in a pretty good place, but I do think the culture needs a bit more focus. And I am determined we tackle this, starting with me. I really believe in our people, and I want to support them to unlock their potential. Now we get a lot of regular feedback from our colleagues, whether face to face, through surveys, et cetera. And there's a pretty consistent theme: they want to feel listened to, and they feel we should invest more in their experience, giving them better tools, systems, training so they can really excel at their jobs and give better support to the customer. And I agree with them. This is the time we have invested, but we need to go faster.

So how do we really excel at customer -- sorry, colleague success? Well, as I've said, it has to start with the culture. We start in a good place with great people who care. However, some change is required to create a true SaaS culture. I intend to really focus on this and embed a culture that doesn't just value individual contribution but really encourages it and fosters collaboration. We've completely overhauled the performance management system this year in response to colleague feedback, doing away with the outdated twice-yearly performance reviews and replacing it with a regular performance development that encourages much more of a 2-way dialogue and continuous conversations and feedback. We are going to invest more in training and tools with a particular focus on go-to-market.

And that's why we've implemented a pilot project in the U.K. called Perform. Now actually, Perform is quite simple. We've put in place new tools, training, gave colleagues access to common data, which enable them to spend more time on more informed conversations relevant to the customer. The teams then share feedback, celebrate success in regular informal huddles, just like the ones you see here on the screen with Janice and Teresa in Newcastle, who are taking part in one of these informal huddles. That sounds simple. But in 16 weeks, customer retention rates increased, as did productivity, 7-month payback with over GBP 2 million of annualized benefits. The return on investment is reduced churn with customers, higher productivity with colleagues and less voluntary attrition over time. So given the success of this, I'm going to roll it out more widely and invest to accelerate that.

Innovation. So what does great innovation look like at Sage? Well, it has to start with Sage Business Cloud being fully available in our chosen markets and being continually enhanced and leveraging emerging technology. Innovation also comes from the culture that I've been talking about that embraces experimentation and more of a 2-way dialogue between our customers and Sage, but also leveraging collaboration right across the company.

Again, we start in a good place. Sage Business Cloud has been winning awards. Sage 50cloud connected won Expert's Choice Award from FinancesOnline. Sage Intacct is a visionary in the Gartner Magic Quadrant, continuing to innovate heavily recently having launched Sage Intacct Budgeting and Planning, which has already been amazingly successful, as well as now embedding Compass into Sage Intacct so that we can benefit from machine learning in the solution.

We've also recently launched the developer portal. This gives new public APIs enabling us to more successfully embrace third-party developers in a similar way to which we do with customers. This is seeking to deliver a world-class developer experience and enhancing our overall Sage Business Cloud offering. However, the pace of change in the world has accelerated, and so must Sage.

So in order to get to great, we need to get the full capability of Sage Business Cloud in our chosen regions, and to do this, we need to deploy more R&D resource. And specifically, we need to deploy it into building out Sage Business Cloud more fully, including embedding emerging technologies and using feedback from our customers to enhance their experience.

It also means accelerating the geographic availability of Sage Business Cloud through, amongst other things, the internationalization of Sage Intacct, which I'm going to come back to.

But also, combined with this is further investment in the service fabric, and this is something that underpins Sage Business Cloud. Now the service fabric is an architectural pattern that breaks down single-tiered software applications into a collective of separate web services. This opens up the APIs, giving deeper domain expertise and migration pathways. Put very simply, this is the glue. It's the glue that holds it all together, supporting a seamless user experience across the platform. Now the reason this is important is that means we no longer need to continually implement and maintain things like VAT, bank feeds, individual payments integrations across all those individual applications and solutions. What it does is it -- the capability continues to improve and evolve without the heavy lifting from the developers, who are then free to concentrate on the next customer need. So what it basically means is we build once and deploy many times regionally.

So Sage Intacct. Sage Intacct is a market leader in North America. And before we took it internationally and before we took it into new markets, we wanted to prove that it continued to accelerate as part of Sage Business Cloud. With GBP 100 million of ARR as evidence growing at 30%, we are now ready to extend this reach internationally, just as many of our U.S. competitors have done. Sage Intacct is a true cloud-native, multitenant SaaS business where the processes, the systems, the technology, the expertise within the business are optimized both for our existing customers, but also for new customer acquisition. As Derk has already said, this business excels at focus and coherence. And that's why we intend to build on this. And we will commence the program to launch Sage Intacct in Australia and the U.K. and Ireland in 2019, with plans to expand into other regions in the coming years.

So if we take all of this together, combined with the power of Sage Business Cloud, including Sage People and the service fabric, this is a very significant move to accelerate Sage's strategy to drive both new customer acquisition but also migrate our existing customers at scale to the cloud.

So in summary, we intend to allocate an additional GBP 60 million of investment in FY '19. And to do this, we'll focus on the 3 key areas of customer success, colleague success and innovation.

Now given the importance of progressing the innovation agenda, we intend to allocate about 2/3 of the investment to this area, with the remaining 1/3 going on customer and colleague success, although in reality, the 3 areas are inextricably intertwined. And therefore, by investing efficiently in one area, the other 2 automatically benefit. To have impact and to deliver the focus that I've talked about, by definition, we must also stop doing some things in other areas, which brings me to product simplification and why this is another building block in supporting our success.

Now it actually impacts all 3 areas that I've been talking about. Because by sharpening our focus, we are achieving greater clarity and coherence for our customers and for our colleagues, but we're also ensuring that our R&D dollars are targeted at Sage Business Cloud.

Now in FY '18, Sage Business Cloud revenue was around GBP 370 million, the top 2 bits of this chart, which drove an ARR of GBP 434 million. Now we've reviewed all of our products, and we've identified a further GBP 1.1 billion of revenue that comes from customers using solutions where we have a clear migration pathway of being able to offer customers all of the benefits of Sage Business Cloud, so underpinning the opportunity for the further waves of growth that we've previously described. Now this combined revenue of GBP 1.5 billion is already growing faster than the business as a whole and in FY '18 achieved 8% organic and 8% recurring revenue growth. And also importantly, this GBP 1.5 billion of revenue already has 51% subscription penetration.

Now the remaining GBP 350 million revenue, which comes from customers who are using products for which there is no current path to Sage Business Cloud, a significant number of these products have strong brands and market positions. And it is important that we find the right solution, both for customers but also for our colleagues.

We told you today that we're holding Sage Payroll Solutions for sale, and this is a good example of where we've chosen a different value-creation path.

The world is moving faster to the cloud, and whilst we're in a good position, now is the time to accelerate and invest behind that acceleration.

So what does all this mean for FY '19? As Derk sort of alluded to, guidance is based on continuing operations at constant exchange rates and takes into the account -- into account the impact of IFRS 15. On this basis, we expect recurring revenue growth of 8% to 9% with SSRS revenue expected to be flat to down mid-single digits.

Now as the pace of transition increases toward subscription, it may be that the overall rate of revenue growth may decrease in the short term because we are focused on recurring revenue and subscription. We expect the organic operating margin before the additional investments of GBP 60 million to be broadly stable, but therefore, after the investments, resulting in a guided range of around 23% to 25%. Free cash flow will remain strong.

I also want to mention the dividend. In FY '18, we are increasing the dividend by 7%. And going forward, our policy will be to maintain the dividend in real terms. However, the focus is to invest into the business for growth.

So I talked about FY '19, but what about beyond FY '19? Well, first of all, to emphasize, Sage is obviously not the first company to make a transition from a desktop on-premise business to a SaaS business. This is a well-trodden path and one that investors have typically been well rewarded for. Look at [Odaiba] or Ariba, or Autodesk, and there are many other examples. But each of these companies that successfully transitioned to SaaS went through a journey. They went through a journey where their revenues reduced and their costs increased. This is also referred to as well was being called the fish model is referred to as the double dip. And therefore at the end, because the margin has reduced, investors have to swallow the fish. Now the good news is Sage is not a fish. This is our version of the fish model. In the short term, our top line revenue growth may flatten. It may even dip slightly. But recurring revenue is already starting to accelerate, and this will continue.

In the short term, we'll invest more into the business, but we will continue to deliver a strong return on this investment with optionality over further investment or margin enhancements. And over time, we will have built a higher-quality business built on SaaS.

So I've talked about the need for the additional investment of GBP 60 million that will be used to accelerate our execution, of which about 2/3 is on technology and innovation. The key message is we are still committed to delivering the 500 basis points of cost savings that we previously talked about. But in order to do that, it is essential that we invest today. Investment today will yield more efficient growth tomorrow. So really, the decision tree hasn't changed. Sales and marketing investment will vary according to the level of achievable efficient growth.

So let me close by returning to the vision. I think it's pretty clear. Our vision is to become a great SaaS business for customers and colleagues alike. To achieve this, we've already made a number of choices. We are choosing to invest for efficient growth. And I believe now is the time to do that.

We've also made a choice to focus on our strengths, and that means our strategy is centered around customers, colleagues and innovation. And if it doesn't contribute to creating a great SaaS business and it doesn't advance customer success, colleagues success or innovation, we won't be doing it. Thank you.

I'd now like to invite Derk up on to the stage, and we'll take your questions. (inaudible) some roving mics.

QUESTIONS AND ANSWERS

Michael Briest ***UBS Investment Bank, Research Division - MD of Global Technology Research Group & Head of the European Technology Research***

Michael Briest, UBS. Two from me, if I can. So firstly, looking at the GBP 350-odd million of business that's sort of sitting there for value creation. Can you describe, is this likely to be sold? And then you talked about the margin profile, because you said it's good brand, but you're not really investing on the R&D side. And then secondly, in terms of those investments you're making of GBP 60 million this year, I mean, if 2/3 of it is going into product, that's typically R&D and that's people, so I don't see where those costs go away in 2020. Implicitly, is this margin a new starting point for future years?

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

So on the first one, I mean, there's a number of different options for the GBP 350 million, and we're in the early stages of evaluating the right outcome. It is entirely possible that some of that will be disposed of. It's also possible that we may continue to run those product areas for value. And we may find there may be ways of partnering with other people, our business partners, for example, to continue to support those customers. So the important message is that we're being clear that our focus is on driving Sage Business Cloud. And we will evaluate the best option for the customers and the colleagues who comprise in that GBP 350 million. In terms of the investment, I think it's a bit early to say, but my instinct is that we've been asked many times in the past as to whether 10% of revenue on R&D was sufficient. And in the past, we've said we thought it was sufficient. My instinct is, with the way that the world is developing, is that it would be sufficient. And so I suspect that over time, we will need to sustain a higher level of investment in R&D. But over time, what we'll seek to do is do more self-funding. So obviously, we've got cost savings coming through from G&A. I've said in the past that we're very focused on increasing efficiency within go-to-market and some of the investment I've talked about in systems and processes will help make us more efficient in terms of our cost to serve. So whilst I think the R&D over time we probably will spend more, it doesn't necessarily mean that that's a permanent diminution in the margin because we may over time self-fund it. But I do think it's important to accelerate it now in order to get the benefits that I've talked about.

John Peter King ***BofA Merrill Lynch, Research Division - Research Analyst***

It's John King from Merrill Lynch. Two questions as well. So obviously, the cloud at the moment comprises the native cloud and the cloud connected. How -- what's the view on the cloud connected piece? How confident are you that that's something that does not actually need to ultimately migrate to a native product? And then related to that, you mentioned a few other companies have gone through cloud transitions. Most of those businesses have framed the story around subscribers and numbers of subscribers. Just wondering what your plans are on that front, whether do you think it makes sense to give out some kind of units, some non-financial metrics to help us follow along the transition.

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

So I think -- on the first question, I think, yes, the cloud connected strategy has proved to be extremely successful. Customers really like it, particularly the ease of upgrade, the seamless way that we can transition our customers to cloud connected. But I think, ultimately, if you fast forward, all our customers need to have available to them a cloud-native destination. So I think we can debate how quickly that becomes a requirement, but I think it is important that in the end, we build out Sage Business Cloud with both cloud connected and native cloud solutions but we give our customers the choice of which one they want to go to. I think in terms of the second point, look, we have a very wide range of customers. And so we have in the past talked about numbers of overall subscribers, and we've disclosed that we have in excess of 2 million on-plan customers. But the truth is that I think you'll find us going forward talking a bit more in a segmented way because, obviously, Sage Intacct has over 10,000 customers. Enterprise Management has 5,000 customers, but those customers are spending GBP 20,000, GBP 30,000 a year on their solutions. And then at the other end, we've got Sage Accounting, which is less than [GBP 100,000] a year. So look, I'm very open, and I've said previously I'm not focused on winning a subscription numbers war at the lower end of the market. What I'm focused on is what's the revenue, and in particular, what's my value renewal rate. So if I can take Sage as a whole from renewing its current customers from 100% of value to something like what Sage People and Sage Intacct do, that's an enormous price. And I'd rather focus on, if you like, less customers and do the job well than get focused on does that GBP 2 million need to be GBP 3 million. But obviously, overall, in the end, yes, you have to add subscriptions, and you have to increase your ARPU.

John Peter King ***BofA Merrill Lynch, Research Division - Research Analyst***

Can I just follow up on the native cloud optionality? Is your vision there at the moment that in extending the existing assets, you have what you need? Or do you think actually there's further M&A that you might need to do in order to offer up that opportunity for people to migrate?

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

Yes. I think the priority at the moment is to make available what we have, make it available more widely, and as I said through service fabric as well, make it more integrated. Ultimately though, the offering -- offering cloud solutions is about increasing functionality and the level of applications within the cloud. And whilst our focus at the moment is doing that organically, I certainly wouldn't rule out plugging in further functionality that we obtain inorganically.

Adam Dennis Wood ***Morgan Stanley, Research Division - European Technology Equity Analyst***

It's Adam Wood from Morgan Stanley. Can I also ask 2, please? Maybe just, first of all, on the R&D spend. I think in the past, there's been investor feedback around not just the amount of R&D spend but also the pace of change and the pace of innovation that's happened. Could you help us understand, from an internal perspective, what you hope to do to make sure this is not just money that brings extra people in the business, but it actually changes the pace of how quickly you bring products to market? And are you confident that in a pretty hot market for software developers, you can deploy that many and get those people -- get the right people into the business? And maybe secondly, a challenge of subscription transitions for companies that have a lot of indirect distribution. There's been -- this is also quite a difficult transition for partners. Could you maybe help us understand what partner feedback's been and how you hope to manage that part of the transition as well, please?

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

So I think, on the first point, you're spot on. I think I've deliberately used the word innovation rather than R&D or technology because I think it's very important we do 2 things. It is important that we're innovative and that we're very openminded about what is required for Sage Business Cloud, not just to be competitive, but to be beyond competitors. Now I want a best-in-class solution. And I think part of what we're trying to do more of is this -- the key really is collaboration. We have reasonable collaboration, but we need better collaboration. We need to take all the skills we have from whether it be Sage Intacct, Sage People, some of what we're already doing in our organization. We have some -- in Newcastle, in Barcelona, we have some really outstanding people, who we need to bring together, and we need to all be looking at Sage Business Cloud as something that unites us. And I think I've been very open in the past that one of the challenges is we come from a product mentality. So even in its early sort of beginning, Sage Business Cloud is essentially taking products and bringing them together. But in the end, we need groups of people who are looking at how do I make this whole thing better. And I think we're doing a better job of late tapping into the creativity that we have within our organization. The second thing is, absolutely, it's a competitive market, and actually, it's a challenge to build your R&D organizations purely by hiring your own people. I mean, we have, as all -- pretty much all technology companies, we have attrition of 10% to 15% a year. So we have 2,500 R&D people, and every year, 250, 300 of those leave. So we have to replenish those, and we have to hire more. So I'm prepared to be more flexible, I think. We are working now on bringing in some third-party partners where we can, therefore, deploy resources more quickly by partitioning out some of the work to partners rather than doing all internally. Now there's different ways of doing that. We may partner with people who can bring some particular expertise and insight. Or we might redistribute some of the work because we have work that's being done by internal developers that we could probably get third parties to do, and then redistribute those colleagues to work on some of the stuff in Sage Business Cloud. So it's a combination, but we need to be flexible to get this acceleration done.

Adam Dennis Wood ***Morgan Stanley, Research Division - European Technology Equity Analyst***

And just about the partner channel?

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

Sorry, yes, partner. So I think we're seeing that develop over time, right? We said that you're seeing in the Sage 200 acceleration in the U.S., that the partner channel is really getting on site. The next step or the thing that's in progress in the U.S. is bringing the Intacct partner channel and the existing U.S. partner channel together, so that as we migrate customers to native, we've got a more sort of joined up approach, but that's going pretty well. And the other big market where partners are critical is France. And again, I mean, Derk talked about some of the progress that we're now seeing in the cloud connected. So we're seeing -- we're starting to see some early signs of that accelerating, but a bit more to do. And then the other big thing really is actually, [Savi] will need to, over the next year, really kind of build and energize the channel in the U.K. and to get ready to support the Intacct product because we haven't had a really a cloud-native solution at that sort of mid-market enterprise level previously. We've got some pretty excited U.K. partners I think who are really kind of ready to invest behind it, but that's something we need to really focus on. Okay.

Charles Brennan ***Crédit Suisse AG, Research Division - Research Analyst***

It's Charlie Brennan here from Crédit Suisse. Just a couple for me as well. Firstly, back on GBP 350 million of revenue, I missed the profit contribution that, that makes. And then in terms of the simplification, I used to think there being 270 products at Sage. How many products set in that GBP 350 million? And then secondly is more medium-term question. You've talked about doing too many things at Sage at the same time. I guess plenty of people in this room would suggest that trying to drive accelerating top line growth and margin expansion at the same time is one thing too many. Just given the competitive dynamics, do you think it's achievable that medium-term margins rise from 23% to 25%? Or I guess, a different question, is it desirable for margins to go up the medium term?

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

So on the GBP 350 million. The profitability dynamics between the 2 different parts of revenue are broadly -- they're broadly similar. They'll probably change over time in the future, but at the moment, they're broadly similar in the way they absorb sort of central overheads is broadly similar. So I wouldn't -- just not -- there aren't material differences. So I think -- sorry, I forgot. What's the next question?

Charles Brennan ***Crédit Suisse AG, Research Division - Research Analyst***

Just 270 different products.

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

Yes, the different products, sorry. So at the moment, in the GBP 1.5 billion of revenue that we've identified, there's something just under 100 products in there. Now a lot of this depends on how you define a product. But broadly, if we take your 270, we have, over time, reduced that down. So we've reduced that down probably by about 30 or 40. So a rough way of thinking about it is there's something just under 100 in the GBP 1.5 billion, and there's something just over 100 in the GBP 350 million. Should we take some questions at the...

Charles Brennan ***Crédit Suisse AG, Research Division - Research Analyst***

Just on the medium-term with margin expansion.

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

Oh, sorry. Yes.

Charles Brennan ***Crédit Suisse AG, Research Division - Research Analyst***

Why should we have both growth in margin?

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

Well, I think, at the moment, I'm saying that we're making a clear choice to invest in growth, but the message I'm also giving is that it's important that, that growth remains efficient. So I'm trying to position it very clearly. And actually, I thought one of the slides Derk put up, where he showed that if you take into account how we've absorbed the losses in Sage Intacct and Sage People, that the rest of the business is actually running broadly to a 30% margin. And it's important that I think what everyone takes away is the way I'm holding the business accountable is we have a budget that drives the margin at 27%-plus, so that -- so everyone in the business is being held accountable to a level of efficiency and profitability as we've previously defined. What we're now doing is choosing to overinvest, and we will ring-fence and measure the return on investment on that GBP 60 million. Now the big question, and I'm not sure what the answer is yet, is whether for what period of time will I need to repeat that and to what degree could I self-finance it by becoming more efficient. And I'm being very deliberate by not reiterating or giving medium-term guidance because I think with hindsight, that drove behavior internally, which was not the right thing to do to drive long-term value. I'm very focused on making sure that we invest now, drive efficient growth, and then we'll see how that develops. But I -- the takeaway should be that, just because I've become a CEO, I haven't lost that focus on trying to drive the efficiency whilst at the same time investment.

Okay. And then we'll take some of the back because the back is fairly a bit left out.

Unidentified Analyst

Just -- I want to ask you a little bit about new customer acquisition. The business, particularly Intacct and Sage People, has been successful in doing that, but that's been a challenge for you across much of the rest of the business. You've been good at maybe moving people onto cloud connected who are existing customers. How do you see the metrics in terms of new customer acquisition going and the cost of that customer acquisition at the moment? And is that one way of thinking about what you're trying to do to lower that customer acquisition (inaudible)?

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

(inaudible)

Derk Bleeker

Yes, sure. I think in general, I think this year, actually, we've seen significant progress in customer acquisition on cloud connected as well as native cloud. So that's certainly a landmark. In terms of the customer acquisition cost, that is clearly something we are very focused on delivering more of in '19 as we sharpen delivery of the underlying core margin. But actually, we see quite good customer acquisition cost because it's a very -- those are -- tend to be customers that find a very natural path to Sage. So they haven't (inaudible) Sage as a brand, et cetera, as oppose to we lead with our cloud connected solutions in most markets. And therefore, that's where we're spending most of our money on new customer acquisition.

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

And I think where the economics have been poor in the past is really in the smaller business. I've said lots of times that for small business with Sage Accounting, at the very low end, we have struggled to make that work economically. And so whilst we are -- we remain very focused on providing the right solutions, particularly to accountants and making sure that we have the right tools for them, and we're not going to put significant investment into acquiring new customers where the economics don't work. We are going to focus our investment where the economics do work.

Derk Bleeker

And we do see very significant expansion of retention in customers that move to the cloud connected solutions. So I think we've mentioned, across the cloud connected space, retention rates approaching cloud-native solutions. That includes, obviously, retention of new customers, so to speak, to customer value.

Unidentified Analyst

Does that imply a sort of focus on small or medium, but not perhaps entry-level customers, given the products that you have at the moment?

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

Yes. I think it depends on the root. So if a small business or a sole trader acquires the software via an accountant or in some sort of self-served way, that's fine. But what's not fine is if we are -- if a human being from Sage is involved in trying to persuade you to buy something that you then pay GBP 10 a month for, which is what we were starting to do a bit too much of. So as I say, I think the focus has to be on accountants. It's very important for accountants that their clients have tools which allow them to do digital data entry, et cetera. And I wouldn't want to say that we're not supporting that, but I am not focused on trying to achieve a high level of small business users on software that they're paying GBP 10 a month for. I am much more focused on the market where we're talking more like GBP 1,000 a year and above rather than GBP 10 a year -- GBP 10 a month, sorry. Okay. Shall we now take a question at the back so that the back don't feel completely left out?

Neil Steer ***Redburn (Europe) Limited, Research Division - Partner of Software and IT Services Research***

Yes. Neil Steer from Redburn. (inaudible) front next time. In terms of the GBP 350 million of revenues that you're strategically considering the future of, do you know roughly what proportion of that goes to customers who are also buying other products from you? And therefore, as you exit or change the nature of that relationship with the customer overall, how does that change the risk profile of the core block of revenues going forward?

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

Yes. It's relatively small. There is some joint customers, but these are largely discrete, sort of almost niche offerings that have developed over the years where most of the customers take that particular product or service rather than a suite of things from Sage. Any other final questions? Sorry. George?

George O Connor

I'm going to have 2 as well then. Just thinking about Intacct, is the delay getting into the U.K. architectural? Or is it related to go-to-market issues? And then secondly, if we can recall the initial CEO search, is there's still a case for somebody at board level with cloud-native expertise?

Stephen Hare ***The Sage Group plc - CEO, CFO & Executive Director***

So I'm going to take -- let me take the first one. I emphasized that to be really successful in terms of SaaS, it's very important to have a very integrated approach. So as we bring Intacct into the U.K., there are development changes that need to be made, for example, to make it fully compliant with local VAT and tax requirements and so on, but there is also a lead time in terms of building up the partner channel, having professional services capability to implement the product, et cetera. And it's important to do all of that in an integrated way. So we think -- actually by doing it both in Australia and in the U.K. and have a number of similarities, we're sort of leveraging off doing that and almost using Australia as a bit of a pilot to make sure that we get it right. So it's both things. In terms of SaaS expertise, probably more widely a question for Donald in terms of the board as a whole. But if I comment on the leadership team, I think the leadership team has a significant amount of SaaS experience. As I say, one of my early decisions was to put Rob Reid on to the Executive Committee. And I think if you get around the managing directors, the likes of [Savi] again, is a good example, we have a lot of technology capability within this leadership team. And we are increasingly kind of embracing both the Sage Intacct and Sage People team who have done this from scratch. So we'll always be looking to enhance the capability we have within the leadership team, but it doesn't keep me -- it's not something that keeps me awake at night that it is in some way a constraint at the moment. I think we know what we need to do, and we have the team to do it, but we'll always continue to build it, okay?

Okay. Thank you very much, everyone.

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