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SGE.L - Half Year 2018 Sage Group PLC Earnings Call

EVENT DATE/TIME: MAY 02, 2018 / 7:30AM GMT

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PRESENTATION

Stephen Kelly *- The Sage Group plc - CEO & Executive Director*

Hello, and welcome to Sage's FY '18 First Half Results, both to those of you who are in the room today and those of you on the phones.

First of all, please note the safe harbor statement, which you can see in your packs and on the screen behind me.

The agenda for this morning's meeting is detailed on the screen behind me. I'll start by outlining the actions that we've taken to deliver on the second half and resolve the inconsistent sales execution issues identified in the first half. Steve will then give a detailed H1 breakdown and the building blocks to H2 growth. I think it's important then to revisit the market opportunity that we presented at Capital Markets Day and how we're executing against our strategy.

So it's fair to say we were dissatisfied with our first half results, and we acknowledge that we were not where we wanted to be at the end of H1. However, other than isolated areas originally communicated in the trading update on April 13, we have identified no further issues.

We've taken swift and decisive action to manage the areas of inconsistent sales execution, and now we're focused on driving high-quality, sustainable subscription revenue going forward. We will do this with our award-winning technology, Sage Business Cloud.

And in terms of the delivery plan for the second half, we've already taken steps forward. Our plan for success in H2 is focused on 3 areas: one, subscription revenue; two, consistency in Enterprise Management; and thirdly, effective leadership.

Firstly, let's review the actions taken to drive high-quality software subscription revenue. Across Sage, managing director incentives have been selectively realigned to further focus and prioritize on subscription revenue growth. In the U.K. specifically, we've addressed the issues by, firstly, implementing the U.S. playbook of migrating existing customers to cloud connected products, as well as identifying Sage 50 off-plan customers who represent a strong reactivation opportunity.

Secondly, in the Enterprise Management segment, we called out the slippage in Enterprise Management on April 13. This issue was only relevant to the U.S.A. and Middle East and Africa. Of the slippage in the U.S.A. and Middle East and Africa, almost GBP 1 million has already closed in April.

Most of the other opportunities are scheduled to close in H2. In H1, across Sage, Enterprise Management grew at 17%. It's important to note, we've seen no material change in either the external market nor the competitive dynamics. To improve consistency, going forward, we had already implemented a global CRM system to track opportunities precisely. And now we're driving consistent methodology and increased discipline on the CRM usage.

And finally, underpinning these steps, part of business as usual, we've also made some changes to the senior management team. We exited around 30 executives out of 600 to simplify the organization, speed up decision-making and improve accountability. In the Enterprise segment, we've introduced new leadership in the U.S.A. and in Middle East and Africa. The team in the U.K., as mentioned, has begun to use the playbook from the U.S.

So to reiterate, H2 will be all about delivering on the strategy by driving high-quality subscription software revenue; improving consistency in the Enterprise Management segment; and thirdly, embedding leadership to accelerate subscription growth.

Today, we reaffirm the guidance given to the market on April 13 of around 7% organic revenue growth and organic operating margin guidance of around 27.5%.

Now I'd like to hand over to our CFO, Steve Hare, who will outline the building blocks to achieve FY '18 guidance and the foundations for FY '19. Steve?

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

Thank you, Stephen, and I'd like to add my welcome to today's results presentation. As usual, I'll provide more color on the first half performance following the pre-announcement on April 13.

So I want to start with 3 key messages, which are really quite simple. Firstly, the underlying business remains strong. The inconsistent sales execution in the first half that Stephen has talked to has been addressed with clear delivery plans in place. Secondly, there is a laser focus on subscription. Recurring revenue is very important, and we already have 78% of group revenue as recurring. And indeed, we already have 44% of the business on software subscription, but we do need to increase this further. And finally, number three, I'll also show what underpins our confidence in achieving the revised guidance of around 7% revenue growth and 27.5% operating margin.

Now as always, I'll lead with revenue. Organic revenue grew 6.3% in the year -- in the half year, and this was underpinned by Sage Business Cloud revenue of GBP 164 million, which is a 64% growth over the same period last year.

Now it's important to pause for a moment here and reflect that in FY '14, revenue from cloud products was just GBP 3 million, and that was made up entirely of Sage Accounting. So there has been substantial progress. And in particular, the cloud connected strategy is proving to be very popular with customers.

Now Sage Business Cloud annualized recurring revenue grew 57% to GBP 336 million. Now both of these metrics are equally important, with the ARR measure showing the underlying run rate, and the absolute revenue of GBP 164 million being what we've recognized as revenue in the first half.

The operating margin of 24.5% is in line with plans to front-load investment as well as absorbing, as anticipated, investments made in driving growth in Sage Intacct and Sage People. This had about a 200 basis point impact. It's also worth remembering that the North American Payments business that was sold last year was profitable, and so we have compensated for that lost contribution.

You can actually see this point more clearly on this slide. The underlying EPS last year included the Payments business. So if you take that out and then you normalize for Sage Intacct and Sage People, actually, the underlying improvement in adjusted earnings is 16%. If you put this another way, we have effectively managed an important shift in the portfolio, and I'll come back to this when I talk about margin and how we've reinvested our savings.

As always, we disclose non-GAAP EBITDA, which is 27%. Although not on the slide, just a quick word on tax. The effective underlying tax rate is 26%, in line with where we expected to be. And we will continue to maintain an effective tax rate in the region of 25% to 27% over the medium term.

So let's turn now to the capital metrics. This is a very important slide. It clearly highlights the strength of the fundamentals in the underlying business. I'm not going to go through all the detail on this slide, but focus on some of the highlights across the bottom.

But if we start with underlying cash flow from operating activities of GBP 221 million and the cash conversion of 99%, and this is after spending GBP 18 million on capital expenditure. As always, we will continue to invest in both IT systems and facilities, and this is the main component of capital expenditure. But we also remain committed to driving strong cash conversion, as we've always done.

Free cash flow as a percentage of revenue was 17%, right in the middle of the guided range of 15% to 20%. Net debt-to-EBITDA was 1.4x, again, well within the 1 to 2x range, and this is after significant acquisitions last year, which temporarily increased the leverage to the upper end of the range in the second half of last year. We will continue to report return on capital employed, but only annually, so we will declare that at the year-end.

Now you can expect leverage to trend downwards in the second half towards 1x by the end of the year as we focus on organic revenue growth and delivering the second half. We also announced an interim dividend of 5.65p, an 8% increase on last year.

So let's take a look at the revenue categories now. This slide pulls out the revenue mix and how it's evolved over the first half. As Stephen explained, recurring revenue growth of 6% must accelerate, and this needs to be driven by subscription. The growth was underpinned by software subscription growth of 25%, largely offset by the expected decline in other recurring of 11%, as we continue to migrate our maintenance and support customers to subscription. Although the recurring revenue and subscription growth is slower than prior periods, there are some real positive signs of momentum.

If you look specifically at the mix, as I mentioned, software subscription penetration has reached 44%, reflecting the success of the cloud connected migration that drove a recurring revenue penetration of 78%. Software and software-related services growth of 7% was better than it has been in the past. The underlying driver of this growth is services, which was boosted by the bundled service offerings in the U.K. that have now been discontinued. Enterprise Management software licenses grew 12%, and this was offset by the expected decline in other license sales as we transition to subscription. It is worth saying that Enterprise Management as a whole, although impacted by slippage, still achieved a growth of 17%.

As we look forward into the second half, you can expect the trajectory to improve as the business focuses on accelerating subscription revenue and expect recurring revenue for the year to be around 7%. Underlying services growth will continue to be healthy, however, unlikely to be at the same rate as the first half. But the Enterprise Management licenses, as previously stated, we -- the slippage, we expect this to recover in the second half.

Now before I move on, I just wanted to provide some context on the impact of the business driving to a subscription model. Let's take the example of a GBP 1 million enterprise contract with GBP 200,000 of maintenance and support attached. When booked as a license contract, all of the license revenue is recognized at the point of sale and the M&S fees over the period of the contract. So if you take this as an example, if we booked this contract in April, we would recognize a total revenue of GBP 1.1 million, i.e., the full value of the license and half of the M&S fee. If we book that same contract in September, we'd still deliver about GBP 1 million of revenue, but it'd only be about a month's worth of maintenance and support.

Now let's consider that same contract booked on subscription. Typically, the annual value of the contracts of subscription would be around 1/3, but let's keep the math simple and say it's GBP 500,000 a year. So if we booked that subscription contract in April, we would recognize GBP 250,000 of revenue. If that same contract was booked in September, the revenue would be GBP 40,000. Same customer, same product, but driving revenues of between GBP 1.1 million and GBP 40,000, depending on the timing of the sale and how the contract is sold.

This shows that turning the run rate of recognized recurring revenue and specifically, subscription, takes a little longer, but it also shows why the ARR run rate is such an important metric. It's also important to remember that, typically, the lifetime revenue of a customer on subscription is at least twice that of a license contract. And as renewal rates are driven higher, this differential increases further.

So let's talk about the sources of growth for the second half, reasons to believe, if you like. As Stephen said, the inconsistency in sales execution has been tackled and was in a relatively small number of areas. So I now want to set out the key reasons that underpin our confidence for the second half and why we believe we will achieve around 7% revenue growth for the full year.

Firstly, acceleration of cloud connected. As I referenced at Capital Markets Day, this is a key pillar to the ways of growth strategy. We have already seen success in North America, but also in the U.K. Despite the relatively slow start, there are reasons to be optimistic. It's worth noting that in the U.K., we do have 50,000 cloud connected customers that generated in excess of GBP 22 million of revenue in the first half.

In addition, we've implemented new sales processes that incorporate the learnings from North America's successful cloud migration. We've also made good progress at identifying off-plan customers targeted for reactivation. And in fact, in the U.K. alone, we now have a target list of nearly 100,000 off-plan customers.

At Capital Markets Day, I gave some illustrations of the monetary opportunity of this off-plan base. I said at the time, typically, if we could reactivate an off-plan Sage 50 customer and charge them, say, GBP 500 per annum, so imagine if we reactivated even half of this targeted off-plan base, that would deliver GBP 25 million of annualized revenue.

Now in those regions where we've recently launched the cloud connected products, there are some early signs of success. In 6 months, France has grown cloud connected revenue to GBP 10 million from a base of virtually nothing. In Spain, cloud connected revenue in the half has grown to GBP 7 million. So there's more to come as we roll out these products.

Secondly, Enterprise Management. The issue was isolated to 2 regions. It is worth reflecting that almost half of the Enterprise Management business is in France. And you may remember 2 or 3 years ago, this was not growing. In the first half, the Enterprise Management business in France grew 29%. As Stephen has already said, for Enterprise Management, we have a single CRM system. And we are now focused on driving consistent discipline around pipeline visibility and adherence to sales processes. And we are confident that visibility will improve, and we will recover much of the license slippage.

And thirdly, France. In the first half, France returned to growth, albeit a relatively modest number, and is carrying this improved performance into the second half, which, when you combine that with the reduced impact of upfront fees and a reengaged partner channel, supports continued progress. And also, overall, you can expect both Sage Intacct and Sage People to continue to deliver high growth, building on the success already achieved, all of which gives a platform for growth in the second half.

So let's turn now to another important measure, annualized software subscriber growth. What's really important on this slide is the sources of growth. There is positive momentum with overall growth in ASB of 30% to GBP 820 million. Almost 70% of this growth is coming from Sage Business Cloud, which is made up of both cloud connected and cloud native solutions. But the chart does clearly show the power of cloud connected Sage 50 and Sage 200 solutions that, combined, have added GBP 89 million of annualized growth. Now I've already been through the key sources of this.

Within cloud native, Sage Intacct and Sage People continue to deliver a strong growth trajectory. And as I commented at the year-end, it's also encouraging that within this category, Sage Accounting is now contributing and, in this period, added GBP 8 million to the cloud native growth. Now the desktop column is made up of customers who are using an on-premise or desktop product but are on a subscription contract. So most of these, we would expect, over time, to migrate to either a cloud connected or a cloud native solution.

Included within this column, the desktop growth column, is GBP 34 million attributable to Sage 50 customers. So these are Sage 50 customers who are on the latest desktop versions but are on a subscription contract. Clearly, the next stage is to encourage these customers to migrate to cloud connected, so you can expect much of this base to transition again in due course to cloud connected modules.

But what's important as well to take away from this slide is the run rate or the implied growth trajectory of the annualized subscription base of 30% versus the recognized software subscription growth of 25%. So what does that mean? The ASB points to the momentum in the business because it's calculated using the latest month, so basically, this is the run rate that we carried in March, and saw signposts to the underlying growth as we look into the second half.

So let's now look at the regions for a bit of color. As always, grouped the regions together into 3, but I'll make comments on the sub-geographies as we go through.

So let's start with Europe. The first half was mixed in Europe. Recurring revenue representing 77% of total revenue, and software subscription increasing to 40% from 36%. Now it's important to remember that U.K. and France is nearly 70% of the revenue in this region. And although neither of them produced any meaningful recurring revenue growth in the first half, both are carrying a positive trajectory into the second half.

Now U.K. grew 4%, and I've already discussed the underlying performance, and I gave an illustration of the Sage 50 reactivation opportunity. But I would just like to emphasize again, as I said at Capital Markets Day, the U.K. has the largest off-plan Sage 50 customer base of any region, and we would expect to see a much improved delivery of cloud connected migration in the second half. I've already been through the key elements of the first half and second half performance for France, so I won't repeat myself here.

Central Europe was very strong, 11% organic revenue and 12% recurring revenue growth, reflecting the strength in the Sage 200 family, but also particularly in the partner channel. Iberia was also robust at 7%. I'd also like to give a shout-out to some of the smaller countries. Poland grew total revenue by 11% and recurring revenue by 19%; but a standout performance from Portugal, growing both overall and recurring revenue by 25%.

So the focus in the second half is clearly the U.K. and France because, as I said, they represent nearly 70% of European revenue and indeed 37% of group revenue. So clearly, their recovery, particularly on recurring revenue, is important.

So turning now to North America. North America recurring revenue penetration is now 82%, the highest of all of our regions. Software subscription penetration is 42%. It is worth reflecting just for a moment that in FY '16, North America was growing at 4%, and software subscription penetration was 14%. Now Stephen will talk more to how this advancement has been achieved later in his presentation. But the migration of existing customers has been a major driver in the U.S.A, driving 89% growth in cloud connected products.

Canada also achieved double-digit organic and recurring revenue growth. And Sage Intacct continued new customer acquisition momentum, driving an annualized recurring revenue of 31%. So in North America, the focus for the second half is to continue the drive and the migration to subscription, acceleration in Enterprise Management and to continue to build on the success of Sage Intacct.

In International, again, some inconsistencies, but it was mainly enterprise. As you can see from the slide, recurring revenue grew 8% in this region. Actually, in International, the recurring revenue penetration is 75%, but software subscription penetration is very high at 60%, reflecting a subscription-first strategy in this region, which typically has a lower M&S base than the other regions.

Although Africa, Middle East grew at 5%, this lower number was almost entirely driven by enterprise slippage, particularly in the Middle East and West Africa. Overall recurring revenue in Africa and Middle East was 11%, and this was partly driven by a very strong Sage Accounting performance showing growth of 59%.

The Brazil decline of 1% is in line with expectations. As at the year-end, given the turbulent economic conditions in the start-up segment, we operate a policy of advanced payment to minimize debt collection issues. This has resulted in the quality of customers being much improved. And today, in Brazil, we have 57,000 active start-up customers, all using the product and paying for it in advance.

In Australia, we achieved double-digit growth, certainly the first time since I've been with Sage that this region has shown such trajectory. So in International, the focus is Enterprise Management in Africa and Middle East, and again, continued subscription momentum.

Let's now talk about operating margin. I referred to this slide earlier when I was talking about earnings per share. This slide shows that we continue to drive cost improvements and to deliver G&A savings. And further cost savings will be -- are to be expected in the second half as we continue to drive efficiencies in processes across the back office.

If you look at the chart, we have split out Sage Intacct and Sage People. So for the first time, what you can see on this chart is that we've actually started to deliver some small productivity savings or efficiencies in the go-to-market function as well as in G&A.

What we've then done with those savings is we've reinvested them, firstly, into product development, where we now have 58% of the product development team focused solely on Sage Business Cloud, delivering product mobility and enhanced portfolio and feature offerings. The key point, however, is that most of the savings, as you can see, were reinvested into Sage Intacct and Sage People, both of which are showing high-quality growth, pointing therefore to return on investment.

So to summarize. The key messages to take away are: the first half sales execution issues have been both identified and addressed, and the underlying business remains strong. We are more focused than ever on subscription, and this is reflected in the plan for the second half, and so underpins our confidence in achieving the guidance.

And with that, I'll hand back to Stephen.

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

Steve, thanks very much, and I think great context for the building blocks in place for the second half.

I mentioned our dissatisfaction with H1 right up front and that we've taken swift steps to address the sales execution issues we identified in the first half. However, when we take a step back from day-to-day operations, I think it is important to ask ourselves, do we have confidence in the strategy? The answer is a resounding yes.

So let's see how we're executing against our strategy with reference to what we shared with you at the Capital Markets Day. The market opportunity, just to remind us. This market opportunity remains significant at $28 billion with a target market of 82,000,000 businesses and 13% annual growth in the cloud. Our competition remains fragmented and localized. And there is no significant global competitor, especially in the scale-up segment where we are the market leader and where we're already seeing significant success with our cloud-collected products.

As we described at Capital Markets Day, in technology, normally, a global market leader eventually emerges. The catalyst of change, such as cloud, artificial intelligence and other technologies, are accelerating growth and consolidation in the market. We believe Sage is uniquely positioned to seize this opportunity.

There are 3 key foundations that support our unique position in the marketplace. The first of these is the Sage brand promise of trust for our deeply integrated local products that are 100% compliant, 100% of the time, supported by unrivaled customer service. At a time when some of our competitors are switching off their direct contact with customers, we are broadening and increasing the range of interactions we are having. Our customer contact remains a key differentiation for us. And this year alone, we'll have approximately 9 million conversations with customers.

Moreover, the trust from our customers translates across all our 23 countries and our 3 million customers around the world. We're the market leader in many of these countries with colleagues on the ground who understand the local landscape, the regulations and speak the local language.

From a product perspective, Sage Business Cloud is the one and only cloud platform needed for a business to manage everything from money to people. According to a leading industry analyst, Sage Business Cloud positions us 12 to 18 months ahead of the competition, and Sage Cloud products have already won multiple awards. Sage Business Cloud provides the widest breadth and depth of cloud products to take a business from start-up to scale-up to grow to a major enterprise. So this is a good point to take a deeper look at the 3 core strategic pillar elements that underpin our future growth: revolutionize business, Customer for Life and new customer acquisition.

So let's look at the technology platform for our strategy, Sage Business Cloud. It was launched in Northern Europe, U.S.A. and Canada in October 2017, with further rollouts in Europe throughout the first half of the year. We have relentlessly improved and enriched the product experience for customers, significantly increased in automation and boosting their productivity as a result.

For example, with Stripe, customers can set up and receive mobile and web payments in just minutes. Our Go Cardless integration with easy on-boarding increases automation and saves customers approximately 1 day a month in administration. Independent market analyst, Forrester, found that Sage Enterprise Management delivered around 200% return on investment within the first 6 months for manufacturing, distribution and service companies. Sage Business Cloud is receiving rave reviews and making a material difference to the lives of our customers, saving them time and money.

Now moving on to Customers for Life. As we outlined at Capital Markets Day, there will be waves of growth as we execute on our strategy. The first wave for the next 18 to 24 months is driven by our cloud connected solutions as we migrate our existing customers to subscription and Sage Business Cloud. This has already been a significant growth driver in the first half. Across Sage, cloud connected solutions now represent over GBP 200 million of annualized recurring revenue with over 70% growth. These solutions are enhancing flexibility and mobility, with time to value for our customers within minutes or hours rather than the old world of days and months. In the first half, we've seen success in the U.S.A. as they drive premium value with our existing customers.

I just want to take just a minute to look at the success that Steve said of our cloud connected strategy with a deeper dive into our North American business. Steve mentioned this earlier, back in 2016, North America was growing just at 4% and subscription revenue was 14% of total revenues. I think at the time, there was certainly skepticism of cloud connected strategy. At that time, many said that this highly adopted cloud region, customers would only want a native cloud solution. So going back a couple of years, the partners were disengaged and were actually moving to competitor products. And there was a lack of strong leadership in the U.S.A.

If we look at North America today, we can see wholesale changes. First of all, Nancy Harris, Managing Director, came into the role 18 months ago and has implemented a high-performance, fast-paced SaaS culture. Secondly, we started to see the acceleration of the Sage 200 cloud endorsed by supportive partners and after some initial resistance 18 months ago. Today, subscription revenue penetration stands at 42%, and the region is growing double-digit. Cloud connected solutions have been a key contributor to this success.

The U.S. has shown us how to drive cloud connected wave of growth, and we're now using their playbook for success elsewhere as we roll out the cloud connected strategy. We believe that Sage can show Continental Europe the pathway to the cloud, where cloud adoption in Continental Europe is still in its infancy.

As Steve mentioned, in Spain, our cloud connected solutions were launched just 6 months ago in that country and already driving GBP 7 million of revenue. That's over 10% of the total revenue in just 6 months, in a country where only 12% of financial spend is on the cloud. In France, where we've seen a return to growth, Laurent Dechaux joined in November 2017 and hit the ground running. He's reengaged the partners who are now embracing the cloud connected strategy. We have confidence in the plans for growth in the second half in France.

The common factors here are strong leaders with clear plans and flawless execution underpinned by market-leading cloud connected products. We expect cloud connected strategy to drive significant momentum in the second half and into FY '19.

New customer acquisition. So some good progress in Customers for Life as the first wave of the growth driver. But at Capital Markets Day, we told you in the medium term, from around 18 to 24 months, the growth driver for the second wave will be new customer acquisition as Sage Business Cloud starts to become even more significant.

There are already positive signs of new customer acquisition, and I want to call out some specific successes in Sage Intacct, Sage People and Sage Accounting. Sage Intacct continues to show strong momentum, delivering ARR growth of 31% in the first half, led by Rob Reid, who many of you met at Capital Markets Day, and supported by an experienced management team who understand the SaaS culture. Sage Intacct has been voted the best place to work in the Bay Area by several independent sources. Moreover, Sage Intacct is leveraging the whole wider Sage family. In the indirect channel, there are now 14 existing Sage partners that are exclusive sellers of Sage Intacct as their cloud solution.

Sage People delivered ARR growth of 62% in the first half, with 4 contracts signed over GBP 100,000 ACV and driving significant new customer acquisition. Sage People was launched in Germany, Canada and Australia earlier this year and will drive further momentum into the second half.

Sage Accounting ARR is growing at 42%. Here, I want to draw attention to what we've been doing with the accountants channel in the United Kingdom. When Steve and I started at Sage, the accountant channel had received little focus. In the last year or so, Sage has had a laser focus on rebuilding relationships with accountants. As an example, in the U.K. in the first half, we've had face-to-face contacts with over 4,000 accountants, and we've held 32 U.K. city events interacting with local accountants across the country. We know this face-to-face contact with accountants is invaluable, and the momentum with accountants is growing with record new subscription months in February and March for Sage Accounting in the U.K.

In summary, we're already executing against the strategy outlined at Capital Markets Day with significant progress in the Customer for Life strategy, supported by encouraging signs for new customer acquisition, all of which is underpinned by Sage Business Cloud. And just to remind ourselves, Sage Business Cloud annualized recurring revenue is already GBP 336 million, growing at 57%. Now interestingly, if this was a stand-alone business, that would position Sage Business Cloud as one of the world's top 15 subscription cloud companies globally.

So bringing ourselves back to today and looking at our outlook for FY '18. By focusing on the 3 areas I laid out upfront, we've addressed the isolated sales execution issues, and Steve has clearly articulated the plan for H2 growth. We are confident that Sage will achieve guidance of around 7% organic revenue growth and an organic operating margin of around 27.5%. The strategy that we laid out at Capital Markets Day is unchanged, and there is no change in the external market nor the competitive dynamics, and the market opportunity ahead of us is as attractive as ever. We are uniquely positioned to execute on our strategy, and Sage Business Cloud provides the platform for our success in FY '18 into FY '19 and beyond.

And with that, I'd love to invite Steve back up and open up for your Q&A. And if I could ask for, possibly, when you ask your question, state your name and your company. Thank you very much.

QUESTIONS AND ANSWERS

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

Let's start with the Stacy. And we got, I think, roving mics. Here we go. Great, thanks. Thanks, [Harry].

Stacy Elizabeth Pollard - *JP Morgan Chase & Co, Research Division - Head of Software and IT Equity Research*

Stacy Pollard with JPMorgan. You talked right at the end about new customer acquisition. You always tell us to ask about that and I think I almost always do. So to fully understand, though, to what degree do you really need new customer acquisition to achieve that top line acceleration to 10%? And to kind of break that down, let's say of the 10% growth, say, you're there on 3 or 4 years, what percentage of that would be from new customers, what percentage, let's say, on price increases and then what percentage in cross-selling? And then maybe a quick follow-up.

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

Sure. So I think if you go back to what was said at Capital Markets Day, some of this depends on the pace at which we execute the cloud connected strategy. So obviously, we've said that it's gone a bit slower in the first half in the U.K. than we would have liked. But actually, if we execute at the appropriate pace on cloud connected, we could get pretty close to 10% or even achieve 10% largely through the installed base. The issue, however, though, is obviously sustaining it. So as I said at Capital Markets Day, once you've achieved that initial wave of growth from the installed base because we're migrating customers to subscription on an average of a 20% premium, once you've migrated everybody, you've then got an installed base play that probably grows at about 5% through price and additional value. So you need new customer acquisition at that point to make up the rest to get to 10%. So I think the way to think about it is the first part of the journey to 10%, whether we actually quite get there all through installed base, you could argue maybe there's a little bit of NCA. But the -- it doesn't require a significant acceleration in NCA from where we are today. But in 18, 24 months' time, NCA needs to have kicked in to probably contribute about half the growth. David? Conveniently placed for the microphone.

David Iain Toms - *Numis Securities Limited, Research Division - Analyst*

It's David Toms from Numis. Can we just dig into the quarterly cadence a little bit more, both historic and future? Q1, a little bit light at the time, you told us impact from taking salespeople off the phones. You put the people back on the phones in Q2, performance got a bit worse. Q3, should we expect a resurgence there? Or was it all down to Q4? And then how does the SSRS comp affect your views for Q4, both the historic and the future and the question within that?

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

Yes. Maybe what we called out is the sales execution issues that were relevant in the recurring revenue model in both Q1 and Q2. And I think what we've done over the last 30 days is really kick in the cadence where we get back to daily, weekly, monthly, where there is that intensity that you have in the subscription business. And then specifically, in terms -- obviously, we provide you with annual guidance. We reaffirm that today. We've given no outlook on a quarterly basis, though.

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

What I will say is that what you should -- what you'll be able to see in Q3 is evidence of progress on recurring and subscription. So what's happened in the first half -- and it's not across the board. So obviously, North America, Central Europe, et cetera, there are -- there is clear evidence of momentum on both subscription and recurring revenue. But as I said in my presentation, both the U.K. and France delivered, basically, no recurring revenue growth in the first half, and that's 37% of group revenues. So what you'll see in the second half is both of those starting to deliver recurring revenue -- sequential recurring revenue. And you'll see some improvement, hopefully, as well in the top line. But the thing to look for in Q3 is recurring revenue.

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

Okay. Let's go down to John. Just keeping -- the first girl, I haven't got very good eyesight to see the back, so apologies, we will switch next time to the back. Go on, John.

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

It's John King from Merrill Lynch. Actually, probably a couple of questions on the margin for you, Steve. Around the seasonality, we've seen quite a marked seasonality in your margins since you guys have been in charge of the business. That's not something we were used to seeing before. Maybe just explain what's going on there because I guess it's not inherent seasonality, it's more the cadence of how you're making efficiencies in investing, but just explain that and perhaps how that informs the confidence for the guidance? And also, if you could also clarify on the margin targets. Reading through the release, it feels like you're flagging there's more capacity potentially to further bolt-on M&A. So the 27% margin, does that include any dilutive impact from M&A? Or is that still something we need to factor in as and when you make the deals?

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

So I'll take the first one. Most of the seasonality really comes from the phasing of marketing expenditure. Now -- and also, as we -- as a great proportion of the business becomes subscription, obviously, you get this impact that I was trying to illustrate in my presentation that you get less rev rec but you still have to invest behind that. So as a proportion, front-loading that sort of sales and marketing to try and drive that subscription growth means you do get -- it is front-loaded. But it's not people, it's variable marketing expenditure, mainly. I think over time as well, obviously, as we get a better cadence on subscription, we should get a smoother revenue path. So although the business is not inherently seasonal, when you look at the trend of revenue historically, we tend to have a pretty weak Q1. We then recover with the Q2. We then have a slightly softer Q3, and then it all comes back in Q4, which is a sort of classic software license-type cadence. In subscription, that's not how it should be. It should be much more consistent, so we are continuing to work on that. So when we use words like consistent, disciplined, sales process, that's what some of that language is about. In a subscription model, you have to be on it every day. You can't pull the rabbit out of the hat the last week of the month by doing a big license deal, and that takes a while. In some countries, we've got that cadence, but we haven't got it universally. And then in terms of the -- yes, we're saying, look, we're focused on driving organic growth. So we're not -- you won't see us doing a Intacct-style acquisition anytime soon. But what we may do is, yes, little bolt-ons. And the guidance is organic operating margin, but I don't think you should -- you shouldn't expect that we would do anything which would materially dilute the margin, but I'm not going to say it is an organic guidance.

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

It's probably worth just talking about this year in terms of absorbing the losses from Sage Intacct and Sage People.

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

Yes, I mean, as I said in my presentation, we said at the time when we did the Intacct and People acquisitions that we were going to -- we would treat those as organic. So some people said, oh, well, that's not kind of fair. You're taking them into your revenue. But we're taking them into the cost as well. So -- and we probably absorb that. So I think it's quite a strong statement that we've taken 200 basis points of margin, and we haven't just stuck it into the core business. We've put it into the 2 businesses that are growing the fastest to drive that return on investment. I think it's important discipline. I think the second thing is, although we reduced our revenue guidance, we kept our margin guidance the same. Again, that shows you the confidence that we have in terms of how we're controlling our cost structure. Because if you think about it, taking a percentage out of the revenue means we've taken kind of GBP 16 million, GBP 17 million out of the top line in a 80% gross margin. So we lost GBP 15 million -- GBP 14 million, GBP 15 million against the bottom line, and we're still delivering the same percentage. So I think you can feel confident that when it comes to managing the cost structure, allocating our capital and resources, we're all over it. And we just need to now make sure that these patches of slightly inconsistent sales operation or sales execution that we get that cadence back and really drive the growth through subscription.

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

Right. Question, anyone? So it's all done. Why don't we go over to take the call over to my -- yes, Charlie?

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

It's Charlie Brennan here from Crédit Suisse. Just a couple of questions from me. Firstly, I was surprised to see some exceptional costs in the period. I know you've called them M&A-related rather than transformation costs. But if we ignore the definition, what sort of exceptional charge should we expect for the second half? Secondly, there's obviously plenty of optimism for the second half here. But you've kindly reminded us that you've downticked your revenue expectations by GBP 16 million or GBP 17 million. You've called out a GBP 5 million disappointment in the first half. That implies a GBP 10 million to GBP 12 million downtick in your second half expectations. Can you just detail where that disappointment is coming from in the second half? And the third one is just on these services bundles in the U.K. Can you explain, firstly, what they are? And secondly, how much revenue is attributable to those services bundles in H1 that you've effectively discontinued?

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

So if I take the exceptional first. So without getting into accounting technicalities here, there are absolutely categorically no operating exceptionals. What you're calling out, Charlie, is -- and we have 2 things. In the first half, we have done some small bolt-on acquisitions. And obviously, when we do those bolt-on acquisitions, we incur costs in buying those companies. We don't charge that through the operating line. That's part of buying a company. That's not an operating exceptional, it's a deal cost, and it's perfectly reasonable to put that through as a deal cost. And also, there are -- from -- and also, from a cash perspective, obviously, the time we did both Intacct and People, there were related costs, most of which were incurred last year, but they were a small number that flowed through. So I think it's important. Yes, these are very clear accounting policies. There are no operating exceptionals. So we're not taking anything to do with the normal business and trying to treat it as an exceptional. But if we do an

M&A transaction, whether that be an acquisition or disposal, there will be costs related to that, and they will be treated separately because they're not ongoing operating costs.

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

On the assumption there's no further deals, should that number be 0 in the second half?

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

Yes, assuming there's no further deals, unless -- I mean, we've done these -- we've done some small bolt-ons in the first half. I can't remember whether we've charged absolutely every single penny into the first half. But there won't be anything material, unless we do more deals. Sorry, what was the second question?

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

Second was about GBP 5 million out of the GBP 900 million in the first half. Overall, obviously, GBP 60 million, GBP 70 million for the full year with a 1% down and the specificity of that.

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

Yes. So part of what we're signaling is that, obviously, we're not content with the composition of how we've achieved the growth because the recurring revenue growth and the subscription growth has slowed. What's important in the second half is that we do 2 things. We recover any slippage from the first half, but we also make sure that more of the growth is being driven through subscription, and therefore, we carry the right momentum into the second half. And that's the reason that, in my presentation, I emphasized the impact of that sort of GBP 1 million deal because we are making choices in the regions and telling the managing directors that we want focus on subscription, which actually leads into the third point. So what happened in the U.K. on bundled service offerings is that we went to customers who -- these are both payroll and accounting customers who are on maintenance and support contracts. And what we did was we sold them off-bundled offerings of training. So we went to a customer and said, here's some latest things that you need training on or support on. And so we sold them training. But the way we sold them that training was effectively to take some of their maintenance and support value and transfer into training, i.e., we gave them a discount on their M&S and used that money effectively as a credit for training. Now what that does in accounting terms is it reduces your M&S revenue, but it increases your service revenue and it means that you recognize that revenue earlier because the services is obviously at a point in time rather than over a 12-month period. The impact for the year as a whole is minimal because the effect is to pull forward revenue really into the first half. The impact for the U.K. was about GBP 6 million. So what it means is that the M&S declined by about GBP 6 million more than it would have done had we not done this. By the time we get to the year-end, it largely unwinds. And that's why the U.K. didn't produce any recurring revenue growth. Actually, the subscription growth was simply countered by the M&S decline. It was almost identical. We're not doing those anymore.

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

So we did explicitly discontinued service business in the U.K. Mo? Then we go to Michael.

Mohammed Essaji Moawalla - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

It's Mohammed Moawalla from Goldman Sachs. First, maybe I missed it, but can you tell us what the renewal rates are and for the overall business and also if there was any meaningful fluctuation in the U.K.? And then secondly, in the release, as part of the kind of the fix, you identified sort of changes in incentives for some of the MDs. Can you perhaps detail that a bit more? And to what extent does this align with the U.S. and how long did it take once you put that in the U.S.? If there is a kind of a read across there to see how things accelerate in the U.K.

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

Yes, maybe I'll do the first one in terms of [possibility] on renewals. So there was a number of things we've done over the last 30 days. We talked about the playbook from the U.S. in terms of the connected cloud. That's now being driven into the other geographies. We highlighted the U.K., obviously, but also the same applies to France, Spain and the other geography where Sage 50 cloud or 200 cloud exist. The second element is actually, Steve led, with Blair, around making sure the MDs that required the acceleration and focus on subscription were actually tuned accordingly and then incentive plans to actually achieve that for the second half. So I think it sort of relates we're really focused on subscription because I think the quality of the revenue is enhanced, and I think that's exactly what our investors, our board and ourselves want to do to drive subscription growth on Sage Business Cloud. And now the incentives were aligned, but they've even been tuned up a bit more to make sure it's a real resolute focus.

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

Yes, I think it's important to emphasize all the managing directors have incentives, which drive recurring revenue in subscription. But they also have incentives to hit the top line. I mean, we have to hit our overall guidance. And we're not operating a business, which is shifting 100% to subscription because we still sell licenses in Enterprise Management and we still sell services. So what's important is that the managing directors are clearly incentivized to manage that mix. Now in some countries where we -- where the subscription penetration is higher, we can afford to say to the managing director, look, just basically go 100% subscription. France is a good example of that. So the only real thing we're doing in France is if there is resistance from customers on enterprise, and we still sell license, but the default is to drive a subscription. So as Stephen says, what we're doing is making sure that in the second half where there was any risk that we wouldn't -- we're not incentivizing the managing director to hit the right mix. We just fine-tune that because again, it goes back to, if you've got behind on your recurring revenue, you can't catch it up in the second half. So what we didn't want was managing directors who got behind on their recurring revenue saying, hey, well, I might as well just go and sell licenses. No, we're not doing that. We're going to sell subscription, and therefore, here's your target for subscription in the second half, and your incentives are completely aligned with that. It's really important that we get that mix together. On the renewal rates, the blended overall for the group is 86%. Actually, last time, it rounded up. This time, it rounded down. So it has actually slightly improved. And the other thing is that includes Sage Accounting. And the attrition rate on Sage Accounting, particularly in the U.K., have been a bit higher. I mentioned this at the year-end, because we've been churning the lower sort of deals that we did some time ago on the sort of GBP 1, GBP 2 a month type level. So if you strip that out, there is an underlying upward trend. But the upward trend is really simply a mix because as we shift to subscription, subscription has a higher -- generally has a higher renewal rate. So if you split out M&S and subscription, there isn't any material change, it's just a mix shift.

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

And it's probably worth saying, obviously, where we always start is with the customer and the partner. And 3 years ago, there was resistance against subscription. That's much less the case now, and we see that declining even further because I think, as consumers, we're used to whether it's Netflix or Spotify or whatever. Likewise, our customers are much more attuned to subscription, and we're driving value through those subscription bundles. So as long as they appreciate the value add, then they acknowledge their subscription is a good relationship to connect with their sort of strategic partner. So I think you will see the implication of that from the business model change, where customers are much more driving us towards subscription, even in Continental Europe, towards a relationship that will show up in the financials where there will be greater renewal rates because, typically, on subscription, we would expect a 90% renewal rate in terms of our customers; Sage Business Cloud on subscription to be at 90%. And also, that will actually drive up the opportunity for us to have a platform with Sage Business Cloud to provide more value that drives the Customer for Life strategy Steve talked about to Stacy's question. All right, Michael?

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

Michael Briest at UBS. Just coming back to the answer to Charlie's question. Did you know about the bundled services contract? Or was that a decision that was made at local level, which only manifest itself later? And I've got a couple of questions.

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

Yes, we knew about it, but it was taken to a level that I'm not happy with.

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

Okay. And then just 2 proper questions. On the balance sheet, if you're not doing a lot in the way of M&A, you're below 1.5x, have you considered buybacks, given where the share price is? What would trigger that?

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

Yes. So I think it's important, on capital allocation, there's no change at this point in time. We have done buybacks in the past. It's not something we've done of late. But I think we keep -- we always keep these things under review. But there is -- I don't want to signal that there is any change in our view over what we've said on capital allocation in the past.

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

And then just finally, on SSRS, you said at the start of the year, you expected to be broadly flat even with good Q1, good Q2. Is that still the expectation? Or with the strong services, would that be better now?

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

I think we'll see a similar -- you're going to see stronger SSRS continue into the second half because there is still momentum on attached professional services as opposed to service boosters. And also, the slippage on Enterprise Management will come back. So -- and this is -- Enterprise Management is the only place where the customer is still selling, essentially, on-premise products. That is largely on license. And so you're going to see that continuing to score SSRS in the second half.

Vijay Anand Chandrasekaran - *Jefferies LLC, Research Division - Equity Analyst*

It's Vijay Anand from Jefferies. My question is on the U.K. business. I appreciate you're trying to replicate the success in the U.S. as well including the U.K. But U.K. had a strong year in fiscal year '17. I think it grew by 7%. 6 months ago, you had specifically called out the strong performance from Sage 50, Sage 50c and Sage 200. So my question is, why did you feel the need to change anything in the region which seemed to be delivering good results? Where there any one-offs in the fiscal year '17 performance?

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

I think if you look at the totality of U.K. & Ireland, Ireland actually had a strong performance in the first half. Sage People had a performance of, what, 83% growth in the U.K.; Sage Accounting, 54% growth. So there's a lot of bright spots. However, on driving subscription, which is core to the strategy on connected cloud, we think there's a huge opportunity. We've taken our Sage 50 customers, which is a much larger population in the U.K. than it is in the U.S. And seeing what the success has been achieved in the U.S. and Canada, we think that could have been accelerated, and I think Steve has highlighted that in his presentation. So that's an area where we would see as the first wave of growth, moving our customers to cloud connected as key. And therefore, all the things we talked about in terms of the action plan we've taken over the last 30 days were important.

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

I think the U.K. -- your point is the U.K. got off to a good start. So if you go back 12, 18 months, the U.K. started to drive to cloud connected. And as I said, we do have 50,000 cloud connected customers today in the U.K., but we had close to that a year ago. So what's happened in simple terms is there was a bit of a sort of wave of, to put it crudely, of capturing the easy customers. And then what we haven't managed to achieve is this drumbeat, because migrating a customer to cloud is not complicated, but you do need to talk to them. So you need a drumbeat every day of this is how many calls you make, this is the script, and not every customer is the same. So what the U.S. have done well is to take their installed base of customers and do a lot of work to categorize them so this is a -- what vertical are they in, what do we know about this customer? Do they have other products? Do they have payroll? Do they have whatever. So that when we're having a conversation with that customer, it's actually an informed conversation that the customer feels that, oh, this is something that's tailored to me, as opposed to, let me just redo my script as to why you should do cloud connected, okay? And I'm exaggerating to prove a point. Now today now, and it isn't like we're suddenly in April, we changed everything, as we said, we knew this wasn't going to plan some months ago, so we have already started in the U.K. to adopt a different approach. But it is back to this drumbeat. And then what the U.S. have been very successful at is every day, every week, every month, they convert X number of customers, and we have not yet achieved that in the U.K. We've gone in waves and then we've slowed down. But the opportunity in the U.K. is probably bigger than the rest of the world put together on Sage 50.

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

George? George, you may come down here. Yes.

George Christopher O'Connor - *Stifel, Nicolaus & Company, Incorporated, Research Division - Research Analyst*

Of the 30 management departures, how many were from the top 100 group? And what is staff attrition like more generally?

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

Good question, George. There are 30 of -- so VPs and directors, 600 population across the company, most of whom of the 30 have been in the functions. And I think, again, it's the sort of journey where Sage is. Obviously, we need to, when we joined, build core competence and functions. On a different stage of journey, you need different levels of seniority, a lot of the cases where someone sets something up with us on a marketing program or digital marketing. Then actually, once it's established, you probably need more junior people to drive that forward. So in terms of the top 100, it's probably a relatively small proportion. And definitely, these typically are not in the front line. These are typically in the function areas. And probably fair to say, actually, this is business as usual at Sage. We're a high-performance company. Like many of you, we work for high-performance companies. And as the business progresses and growth is sort of demanded by all parties, including ourselves, we will need to make sure on an annual basis that we continue to make sure we have the right people doing the right roles. Yes, anything you want to add?

James A. Goodman - *Barclays Bank PLC, Research Division - Research Analyst*

It's James Goodman from Barclays. First question is just on France in terms of the improved outlook for the second half. There, it was driven in the first half mainly by X3 licenses, 20 -- or X3, 29%. In your budget for an improvement in the second half, what are you anticipating in X3? Is it a much broader-based recovery? And the second question, just on the processing business, a smaller chunk now, but growing 2%. Is that the U.K. Payments business, which is struggling in some way? Can you give us some context to that part?

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

Yes, sure.

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

So the first one, more of the French recovery really comes from -- there's less of an impact from the upfront fees that we referred to earlier, so you just get automatically a kind of comparator, if you like. But also, it's really more -- it's more around the recurring and subscription. So particularly, we see good opportunities around the connected -- the cloud connected in the case of France, Sage 100 base. So I think although you'll see improvement in the headline growth rate in France, the big thing to look for is this improvement in the run rate of recurring revenue because, as I say, France is one country where we already have subscription penetration of 60%. And we basically said to the MD, where you can sell on subscription, sell on subscription. We don't want you to sell you on license.

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

Great. Maybe one more question? Go ahead -- yes, sorry...

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

Actually, the drag, to be honest, the drag on growth in the processing line is more payroll processing than it is payments. We've had, in our U.S. payroll processing business, we've had a pretty flat half. The U.K. Payments business is performing pretty well.

Stephen Kelly - *The Sage Group plc - CEO & Executive Director*

One more question? Wow. Okay, well, thank you very much for joining us today, and thank you for your support.
