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Half Year 2020 Sage Group PLC Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the 2020 interim results presentation for The Sage Group plc conference call. (Operator Instructions) I must advise you that this conference is being recorded today, on Wednesday, the 13th of May 2020.

I would now like to hand the conference over to your first speaker today, Steve Hare, Chief Executive Officer. Please go ahead, sir.

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

Thanks very much, and hello, everyone, and welcome to Sage's interim results presentation webcast. I'm Steve Hare, I'm the Chief Executive of Sage. And also on the line with me is our CFO, Jonathan Howell.

So firstly, I'd just like to say thanks very much for listening in today, particularly during the somewhat uncertain times. And I do hope that you and your families and your colleagues are safe and well.

Now before we get going, as always, please just note the safe harbor statement, which you can find on Slide 2.

Turning to the agenda. So in a moment, Jonathan will talk you through our financial performance. But first, I'm going to share some opening remarks about our results, about how COVID-19 is affecting our business and about the actions that we're taking in response. And then later in the presentation, I'll then go into some more detail about our strategic progress, our outlook, and why I believe we're well positioned and prepared for the future.

But let's start by turning first to the highlights of the first half. Now we've had a good first half, with strong financial performance, and we've delivered another consecutive period of growth. We started this financial year with real momentum, following a very good year last year. And we've continued to build sequential annualized recurring revenue during the first half, delivering growth of just under 10% and in line with our expectations. It is worth noting that almost 90% of our business now is high-quality recurring revenue, as other revenue continues to become a much smaller part of the mix. And importantly, we've continued to add subscription revenue, up 26% on last year.

Now supporting our strong financial performance has also been progress in strategic execution. We have a clear vision, and this is to become a great SaaS company for our customers and colleagues alike. And we will achieve this vision by focusing through our 3 strategic lenses: customer success, colleague success and innovation. This hasn't changed since I became CEO in November 2018. And in spite of the uncertainties that we face today, which I'll come to in a minute, it remains unchanged.

In each of these areas, we've made tangible progress in the first half. In customer success, with improved customer experience through new ways of working, more efficient processes and improved technology. In colleague success, we've invested further in our people, our culture, embedding and living our values and becoming more customer-centric, further increasing engagement. In innovation, we've continued to invest in Sage Business Cloud, our single digital environment for our cloud native and cloud connected customers. And finally, we've continued to drive focus, reinforcing the choices we've made to focus on the small and medium customer segments, on the software categories of accounting and financials, people and payroll, and we partner when it comes to payments and banking solutions. We further focused our business portfolio on the Sage Business Cloud opportunity, completing the disposals of Sage Pay and Brazil in the first half. And above all, as I've said before, we're focused on growing recurring and subscription revenue above all other revenue.

So let's touch on COVID-19 and our response to it. This is, first and foremost, a human crisis. We're seeing a profound effect on people and communities around the world. And our thoughts are with those most directly affected by the illness, and indeed, those who've lost loved ones. The pandemic has clearly also introduced considerable economic uncertainty. There are many things we don't know and we can't control. We don't know how the virus will progress or how long the pandemic will last. Decisions on lockdown and support to business are made by governments who are seeking to balance many different things. We cannot predict the level of business failures or new business starts, particularly in the short term, and we cannot predict the depth of any recession that will follow. So I'm going to focus my comments on what we do control and our response and why, therefore, I think Sage is well positioned to navigate what I believe will be a difficult period through to the longer term. But in the longer term, I'm optimistic for the prospects for Sage, for its customers and its stakeholders.

So we've responded to the disruption by focusing on 3 key priorities: the well-being of our people, support for our customers and partners, and the execution of our strategy. And I'm going to talk a little bit about each one.

Starting with our people. Ensuring the health and well-being of our colleagues has been our #1 priority. This is the right thing to do, but it's also the key ingredient to supporting our customers. We are in the relationship business, and I'm proud of how our people have reacted. They supported each other, and they supported our customers. All our offices are currently closed, and our people are working from home. And we will only reopen our offices when we consider it safe to do so. And even then, the return to the office will be gradual and colleague-led.

Secondly, support for our customers, partners and accountants. We know the economic disruption is affecting many small and medium businesses around the world. Most have had to adjust at short notice to new ways of working. And for some, their businesses have been completely disrupted. I'm pleased at how our organization has found ways to offer practical advice and innovative solutions to help those customers in need.

And thirdly, continuing to execute on our strategy. It is natural at times of great challenge to focus just on the near term and to therefore lose focus on longer-term direction. But I am determined that Sage will pursue its vision with the same vigor as before. I believe the cloud opportunity for Sage will be bigger in the long term as cloud adoption by businesses accelerates. We've worked hard to put the foundations in place, and we have the right strategy to succeed.

Now as expected, we are starting to see the economic situation impact our business. Our first half results were largely unaffected, apart from some impact on other revenue towards the end of March. But we're now seeing a slowdown in new customer acquisition as some customers defer the investment decisions. So in April, new customer acquisition ran at roughly half the level we previously expected for the month. We've also seen a very slight increase in churn. All this has led to a slowdown in recurring revenue growth compared to our original expectations. And while we've been actively managing down of the revenue in line with our strategy, the rate of that decline has significantly accelerated. These factors have been taken into account as part of our outlook.

Given the environment, we are implementing a range of mitigating actions to manage our costs and cash while still investing to support the longer-term great prospects of the group.

It's important to note that as things stand today, Sage does not intend to make any redundancies in response to COVID-19. We also do not intend to furlough any colleagues or make use of any government support programs.

The near term is uncertain. We don't know how long or how severe the downturn will be, but we have entered it in a strong position, both operationally and financially. We've built a high-quality business based on 90% recurring revenue. Our balance sheet is resilient. And whilst this crisis will undoubtedly slow the group's trajectory in the near term, the longer-term opportunity for Sage is as compelling as ever. And so I believe it's vital that during this period, we continue to reshape and reposition the group strategically and that we sustain our momentum in innovation and that we continue to invest in the long-term success of Sage.

So now I'm going to hand over to Jonathan, who will take us through the financial review of the first half.

Jonathan Anton George Howell ***The Sage Group plc - CFO & Director***

Thank you, Steve, and welcome to you all. And I hope you are all safe and well.

To start with, I'll run through our financial highlights, which demonstrate the good performance in the first half.

So the key messages are, firstly, high-quality recurring revenue growth. Sage has continued to deliver good strategic and operational execution, which has led to strong growth in recurring revenue of 10.3%. As Steve mentioned, there have been a limited number of -- there has been a limited impact from COVID-19 in the first half. Secondly, on target margin. The organic operating margin of 22.8% is in line with our targets. This reflects good performance in the business and ongoing investment to drive future growth. Thirdly, strong cash conversion. Cash conversion has been particularly strong and remains a core strength for Sage. And finally, a resilient balance sheet with GBP 1.3 billion of cash and available liquidity. And with this, Sage enters the second half in a strong financial position.

So turning now to the P&L. And first, to be clear, the numbers in this presentation are on an organic basis, stripping out the impacts of disposals in the first half, which include Sage Pay and our business in Brazil.

Total revenues increased by 5.7% to GBP 935 million, and recurring revenue is up by 10.3% to GBP 826 million. Organic operating profit is GBP 213 million at a margin of 22.8%. This reflects good underlying performance of the business and ongoing investment to support our strategy. This also includes an additional GBP 13 million charge potential bad debts in connection with COVID-19. Underlying operating profit is GBP 218 million. And a quick word on tax, the underlying effective tax rate was 27%. Going forward, we expect to remain in the range of 25% to 27%. Underlying EPS is 13.75p, which is broadly in line with last year. And we've increased the interim dividend by 2.5% to 5.93p. This reflects the strong performance and cash generation in the first half and is consistent with our policy to maintain the dividend in real terms. Finally, you can see that ARR has increased by 9.8% to GBP 1.7 billion. This reflects good momentum and continued sequential growth in recurring revenue.

So now looking at revenue categories. As you can see, we have delivered recurring revenue growth of 10.3% to GBP 826 million. This is underpinned by strong growth in software subscription of 26% to GBP 582 million, which is an increase of around GBP 120 million on H1 last year. North America and Northern Europe continued to be the standout performers, with recurring revenue growth of 12% and 13%, respectively. This was driven by good momentum from FY '19 and continued execution in the first half in the cloud connected and cloud native portfolios. Other recurring revenue, which is largely maintenance and support, decreased by 15% to GBP 244 million. This reflects the migration of customers to subscription contracts. And other revenue decreased by 20% to GBP 109 million. This reflects the managed decline in licenses and professional services and the impact of COVID-19, which we started to see at the end of March. It's encouraging to see that nearly 90% of our revenue is now recurring and 62% of our revenue is from subscription, up from 52% in H1 '19. Renewal by value is now at 101%. And this shows that in H1, revenue from existing customers grew at a faster rate than churn.

So overall, a strong performance in the first half, which demonstrates good execution in line with our strategy.

Now turning to the portfolio view of revenue. As you can see, the overall future Sage Business Cloud opportunity continues to show strong performance with recurring growth of 12%. Growth in Sage Business Cloud has benefited from strong growth in the second half of FY '19 as well as new customer acquisition, reactivation and migration of customers onto cloud connected and cloud native solutions. Importantly, cloud native solutions have delivered recurring revenue growth of some 31% to GBP 105 million. The growth in cloud connected revenue of 46% to GBP 307 million is principally driven by our major territories of North America and Northern Europe. And the impact of all this is Sage Business Cloud penetration, which is now at 56%. This is up from 44% at H1 last year. Recurring revenue in the non Sage Business Cloud portfolio was broadly flat, in line with our expectations.

Turning now to the regions. North America delivered recurring revenue growth of 12% to GBP 311 million, and Sage Business Cloud penetration is now at some 70%. Cloud connected growth continues to be strong in North America driven by Sage 200 migrations in the U.S. and Sage 50 migrations in Canada. Cloud native growth is driven by Sage Intacct, with recurring revenue growth of 31%.

Northern Europe, that is U.K. and Ireland, has continued to perform well. It has delivered recurring revenue growth of 13% to GBP 187 million. Sage Business Cloud penetration is now at some 80%, up from 59% this time last year. Growth reflects strong performance in the second half of FY '19 as well as new Sage 50 contracts added in H1. Sage Intacct has made a good start in the U.K., adding more new customers than expected in the first half. However, it will not be material to performance in FY '20.

Central and Southern Europe delivered recurring revenue growth of 6% to GBP 250 million. Sage Business Cloud penetration in this region is growing rapidly and now stands at 35% compared to 21% last year. Growth is coming from Sage 50 and Sage 200 cloud connected portfolio as well as local products. France, which is the largest country in this region, grew recurring revenue by 4% to GBP 120 million. This was driven by growth in cloud connected products in FY '19 and by new contracts added in the first half of FY '20.

And finally, the international region has continued to perform well. This delivered recurring revenue growth of 11% to GBP 78 million. Africa and Middle East grew recurring revenue by 15% to GBP 53 million driven by local products and continued strong performance in Sage Business Cloud accounting.

Turning now to cash flow. Underlying cash flow from operating activities was GBP 276 million. Cash conversion of 127% continues to be strong due to sustained improvements in working capital as we transition to subscription. We expect this to trend down in the second half. And this has led to underlying free cash flow generation of GBP 227 million. Net debt has reduced to GBP 238 million, and net debt-to-EBITDA is now at 0.5x.

Just a word on IFRS 16, which Sage adopted in FY '20. This has resulted in an increase of 0.2 in the net debt-to-EBITDA ratio, reflecting operating leases now held on the balance sheet.

The group has around GBP 900 million of cash and more than GBP 400 million of undrawn facilities. This means that cash and available liquidity totals around GBP 1.3 billion. As a result, Sage has a resilient balance sheet underpinned by strong liquidity. In addition, term debt and facilities have a long maturity profile extending to 2025.

Now turning to capital allocation. Sage's disciplined approach remains unchanged as a result of COVID-19. Our strong balance sheet is a key strength as we enter this period of economic uncertainty. In short, our capital allocation priorities are as follows: firstly, organic investment in order to become a great SaaS company; secondly, the group may consider bolt-on acquisitions of complementary technology that will accelerate our strategy; thirdly, our policy is to maintain the dividend in real terms, and in line with that policy and reflecting the good performance and cash generation in the first half, we've increased the interim dividend by 2.5%; and finally, if there is surplus capital, we will consider making additional returns to shareholders. And to that point, Sage announced in April the cancellation of the GBP 250 million share buyback. This decision will further support the group's financial strength going forward.

Moving on to leverage. Our intention to operate in a broad range of 1 to 2x net debt-to-EBITDA over the medium term remains unchanged. However, we will move outside this range from time to time as business needs require. Accordingly, given the current environment, we are comfortable with our net debt-to-EBITDA leverage of 0.5x.

And so to summarize. Firstly, Sage has performed well and in line with the strategy in the first half, resulting in recurring revenue growth of 10.3%. Secondly, we have delivered an organic operating margin of 22.8% in line with our targets. Thirdly, continued strong cash conversion of 127%. This remains a core strength for Sage. And finally, we have a resilient balance sheet to support investment for long-term growth.

Thank you. And now handing back to Steve.

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

Thanks very much, Jonathan.

So look, as you've heard, we've made a good start to the year, and we have a strong financial position to support us through the second half of this financial year and beyond.

But before I talk about strategic progress we've made, I'm just going to take a step back and look at the general direction that we've been traveling in whilst we've been transitioning the business.

This slide shows how over the last 18 months since I became CEO we've accelerated the transition to higher-quality recurring revenues, focusing on subscription and on cloud adoption. We've moved from 44% of group revenue on subscription at the end of FY '18 to 62% today. And as we've said, nearly 90% of our business is now recurring revenue, which means other revenue, which was 22% of the business in FY '18, is down to just 12% today. And you can see on the slide where we're aiming to get to, and we're making good progress towards these targets.

But there's a couple of implications of this changing revenue mix that I really just want to emphasize. Firstly, the overall growth has obviously been slowed by other revenue. But as this declines, it becomes less and less of a drag on the group as a whole. And secondly, as recurring revenue grows within our business mix, we're becoming more resilient, and this resilience is obviously particularly important in times of uncertainty.

But let's go back and look at the drivers of growth for the first half. A year ago, we had GBP 1.54 billion of annualized recurring revenue. Now during the first half, we've improved our renewal rate by value to 101% as migration, cross-sell and upsell more than compensates for churn. On top of this, it's worth emphasizing that over the last year, we've driven around GBP 130 million of ARR growth from new customer acquisition and reactivation. This is important because it shows we've achieved balanced growth from both new customers and also existing customers.

Now look, as we look ahead, our renewal rate by value may ease back as we focus on retaining customers rather than upselling in the current climate. And while we will remain focused on winning market share, consistent with April trading, the level of new customer acquisition is likely to be reduced until market conditions improve.

So I'm going to turn now to the progress we're making, just talk about each of the 3 strategic lenses.

Starting with customers. Customer success means helping our customers become more successful, providing them with solutions and support to directly address their needs, and in so doing, building stronger customer relationships. And in the first half, we made good progress. In the small segment, we focused on improving the end-to-end experience, integrating AutoEntry and CakeHR with Sage Business Cloud accounting as well as upgrading tools and processes. We've also focused on accountants and how we can help make them more successful.

In the medium segment, we've clarified and simplified our industry vertical focus, so that we now are offering the right solution for the right customer, combined with our industry expertise. At our Partner Summit in Orlando in the second quarter, new and long-standing partners who are core to our success appreciated this simplicity and told me it made them better able to serve our shared customers.

Now many customers claim they're dedicated to the success of their customers. Times of crisis are a test of statements like that. And I'm pleased that our customers are seeing us stand by our commitment with a range of support measures in place. We're running webinars covering topics like working remotely and furloughing employees for all small and medium businesses, whether they're Sage customers or not. We have customers and accountants who've told us that Sage have been like a lifeline and that we received -- and we have received really good feedback to our webinars, particularly on topics like job retention. One recent webinar attracted 2,500 participants. We've also allocated additional resource to customer service and support, making it easier for customers to speak directly to one of our advisers.

We've also been innovative in the U.K. by working closely with the government. We've been able to develop a software module, which helps businesses apply for the job retention scheme, automating significant parts of the application process. And our understanding of the government relief available meant we were the first to launch a tool to help businesses understand which schemes they would qualify for.

As we emerge from the immediate reaction phase of the pandemic, we expect these investments in customer experience to further improve our relationships as customers make big decisions about their businesses. And our role is to support them as they consider these next steps.

Turning now to colleagues. Colleague success means building an inclusive culture where people feel valued and motivated. I've said it before and I'll say it again, our people and our culture are one of the most critical ingredients for success. We've continued to invest in our talent development programs, further embedding our values and behaviors. Although no one predicted the test of leadership we face now, I'm happy to see the results of this investment in the actions of our leadership team and the way our people have responded.

Supporting the community is a big part of life at Sage. Sage Foundation is core to our culture. It's a great way to attract and retain talent. And we had more than 12,000 volunteering days contributed by colleagues so far this year. Our most recent Sage Foundation, Big Day In, an online volunteering event to reflect our new working environment, attracted over 1,000 participants in the U.K. alone, giving a combined 475 days of colleague time to good causes.

Whilst everyone is working from home, I, along with other leaders, are using live broadcasts to take questions and address any concerns. And we've assured our people that we will do everything we can to support them and to protect their jobs.

We recognize many people now have additional caring and home schooling commitments, and so we've helped them adapt to these new ways of working, supporting them with e-learning as well as focusing on physical and mental well-being. Their reaction has been quite amazing. Internal pulse survey is telling us that over 90% of our people are happy with our response. And in return, they've shown determination to go above and beyond for our customers and for the company.

And I must say, as a quick aside, it's been very refreshing to meet people's children and pets during our video calls. I think it's helped us all get to know each other a bit better.

When I became CEO, I said creating the right environment for colleagues to succeed would be crucial. So we monitor engagement on a regular basis in many different ways and have seen improvements on every front. But for a real sense of what I'm talking about, I recommend you take a look for yourself at some of the recent messages from Sage colleagues on places like Glassdoor and LinkedIn to see the pride and commitment that our people are showing.

Moving on to innovation. For us, innovation is solving customers' real customer problems by doing things differently, making our solutions more useful, more powerful and more valuable. Now I talked about the Sage Business Cloud vision before. It's at the heart of our technology plans. Sage Business Cloud will become a comprehensive digital environment, comprising cloud platforms, applications and services. Our partners and ISVs will be an integral part of this environment. And we will use Sage's identity management to create a unified customer journey, offering a consistent experience for customers across multiple products and services. For those Apple enthusiasts amongst you, think the way your Apple ID unifies the experience across different Apple products. And we will add and integrate more services and solutions, which both cloud native and cloud connected customers can enjoy. And the vision guides all of our technology investments.

So how are we making this a reality? Well, whether it's increasing the availability of existing solutions or bringing new ones to market, making technology acquisitions or building out the digital environment, step by step, we're putting the pieces in place.

So let's start with the small segment. We've developed and soft launched Sage Business Cloud Accounting for professional users in the U.K. This is a native cloud solution which will be used to attract both new customers, but over time, will offer a migration path for our existing Sage 50 customers wanting a native solution. And I'm really pleased this new version already has been recognized as a leader by IDC in its MarketScape small business assessment. We also acquired CakeHR, a native cloud solution that simplifies and automates HR tasks for small businesses, and we've launched in the U.K. in April.

In the medium segment, Sage Intacct has continued to flourish, successfully gaining early traction in 2 new territories, the U.K. and Australia, with the South African launch planned for later in the year. In the U.K., Sage Intacct contract wins are ahead of plan and have already generated ARR of over GBP 300,000. In the U.S., we've launched Sage Intacct Construction, a specialized solution for the construction and real estate sector.

We're also making progress with initiatives that underpin the whole digital environment. So as an example, we've launched Trust Fabric in partnership with AWS. Trust Fabric will use blockchain technology to create an immutable record of documents transacted across Sage Business Cloud. And we brought together our AI and machine learning capabilities within Sage AI Labs to accelerate the deployment of advanced services across our products. And we've launched Sage Business Cloud Marketplace, enabling our ISVs to promote their Sage Business Cloud solutions to customers.

Now if we turn to the product quadrant. This slide shows our framework, with the objective of filling each customer segment and software category with a native cloud solution available across all our markets. And Sage Intacct, Sage Accounting and CakeHR are good examples of how we're filling this out. Through innovations, Sage has made tangible steps forward in developing a comprehensive set of native cloud services and solutions to become winners in their respective product categories. Investing not just to continue this work, but to accelerate it is one of my key priorities.

So if we turn now to the outlook for the rest of the financial year. And this is consistent with our trading statement, which we issued on the 6th of April. While we had a strong first half, the near term is uncertain, and there's a number of things that we don't control and can't predict. As a result, we do expect recurring revenue growth to be below the previously guided range of 8% to 9%. We do, however, still expect recurring revenue to grow. We also expect that the decline in other revenue will accelerate as customers defer decisions regarding licenses and professional services implementations. And this will have an impact on profit. So our organic operating profit margin will be below our previous guidance of 23%.

So to recap. Sage performed well in the first half, and we made continued progress on our strategic priorities. The business is financially and operationally resilient. And despite the pandemic and the near term uncertainty, I believe the longer-term opportunity for Sage is as compelling as ever. And so we will continue to invest with the objective of long-term value creation for colleagues, customers, partners and shareholders.

Thank you very much. That concludes today's presentation. And Jonathan and I were delighted to take your questions. So I'll hand back to the operator.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Adam Wood from Morgan Stanley.

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

Maybe just, first of all, I wonder -- one of the great things about Sage is you have all of these conversations with the small businesses that you serve. I wonder if you could give us a little bit of insights into what you're hearing from them. Maybe, for example, that churn, could you give a bit more color on slight? Are they asking for holidays on subscription payments or just help on payment terms? And are those discussions different in countries where there's very strong government support for SMBs versus where that support is weaker? That would be the first one.

And then maybe just a headline on the second. Is there a line to understand your draw on margins in terms of where you would ramp up the cost cutting? Or is the commitment to protect the investments in the products there, and you'd be willing to tolerate quite a big degree of margin decline to retain that investment over the second half and into next year?

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

Sure. Thanks, Adam. So on the conversations with customers, I think the -- we're doing constant polling. And obviously, we're all talking to customers live as well. And there's a consistency of -- I think in the longer term, customers are pretty optimistic. They're figuring out how -- it obviously depends which sector they're in, but generally, people are optimistic about the long term. There's no doubt that where government support is available, it's providing greater sort of certainty and greater stability.

I mean, on the churn, it is very slight at the moment. We are talking to customers where they have difficulties or where they've contacted us to say that they want to cancel. And we are offering support through short-term payment holidays and other means of supporting them. And we're seeing a pretty consistent pattern across our different countries, although, as I say, the government support definitely helps.

I think on margin, I'll say a few comments and then I'll just hand over to Jonathan to add to it. I think what's really important is that we preserve our investment for the long term. It's really important that we run the company for the long term, and we continue to invest behind our products and behind our innovation. As I've said a number of times, I'm very keen to preserve our capacity and preserve therefore jobs. But we obviously also have to be financially balanced in the near term, and so we're taking actions that are appropriate to what we currently see.

Jonathan, do you want to add to that?

Jonathan Anton George Howell ***The Sage Group plc - CFO & Director***

Yes. Just in relation to the first part of the question, where we have conversations with customers around their inability to pay in the current environment, on a case-by-case basis, we are looking at payment holidays and extended settlement terms. But at this stage, and it's only 1 month in, the month of April, in the COVID environment, the impact of that on our financial results has not been material.

In terms of costs, exactly as Steve said, that we are determined to continue to invest for the longer-term growth of the business. But of course, we need to be proportionate and sensible, and we will make those decisions to ensure that we balance the short-term requirements of operational efficiency as we move forward into the COVID environment against the longer-term requirements of investing in the business. And so we have put in place some cost-mitigation actions, obviously, around variable costs at this stage. And those include travel and entertainment reduction, marketing that we don't need to do at this stage, we're not going to be doing, and there will be limited restrictions on our hiring program across the group. That is the proportionate response at this stage, and clearly, we will continue to monitor the performance of the business as market conditions change. And if necessary, we'll change cost decisions to ensure that we come in at a sensible margin, albeit lower than the one we initially guided to.

Operator

And your next question comes from the line of Stefan Slowinski from Exane BNP Paribas.

Stefan Julien Henri Slowinski ***Exane BNP Paribas, Research Division - Research Analyst***

Yes. I just had a question around reactivations. So you've given us some indication on kind of new customer additions and where that's trending here as we head into the second half of the fiscal year. Can you give us any trends around the reactivations that you're seeing? Specifically wondering about some of the cloud connect products and some of the remote and mobile functionality that, that provides. Can you actually see a bit of a pickup in demand in some of those products as customers look to work from home or work remotely and get that kind of connectivity? So any color around reactivations would be appreciated.

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

Sure. Jonathan, do you want to comment on that?

Jonathan Anton George Howell ***The Sage Group plc - CFO & Director***

Yes. So look, look, first of all, as you can see, we've given some disclosure in relation to April. We do counsel caution just looking at 1 month in isolation and trying to use that to interpret a trend line for the full year because there are very many factors outside of our control and many uncertainties. So at this stage, we can't be more precise. We have seen a small, slightly higher increase in churn. And as anticipated, and we said in our April announcement, we've seen NCA come down to about 50% of the pre-COVID level. And that is just in the first month.

Within the total portfolio of businesses that we've got, the very strong year last year for Sage 50 included reactivations, particularly in Northern Europe. We are still continuing to see reactivation, but clearly not at those levels. It is a component of overall growth. But as we move more of our product base to cloud native, whether that's in medium segment or small segment, with the new Sage Business Cloud Accounting for professional users coming out, then we imagine it will be more likely to be NCA going forward than reactivation.

Stefan Julien Henri Slowinski ***Exane BNP Paribas, Research Division - Research Analyst***

Okay. That's really helpful. And maybe just a quick follow-up on that then. When you talk about the cloud native business and you've talked about the Sage Accounting Professional soft launch in the U.K., has there been any change in time frame of any of the launches or any of those investments, whether (inaudible) because of the current environment or other (inaudible)?

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

Sure. So I mean, in terms of investments in the product development itself, we haven't made any changes. In fact, if anything, we're looking to accelerate. Where we have made some changes is exactly how we do the launch. And actually, Sage Business Cloud Accounting Professional is a good example of that, where we've launched on time, we've made the product available, but we have not spent the same that we would have been in normal circumstances on sort of marketing and promoting the product. And the reason for that is that we think small, medium businesses are focused and somewhat distracted on the short term on survival, on figuring out what this means for their business. And so a softer launch where we make the product available and we promote its availability, but we don't push it quite so hard. We felt it was appropriate for the current circumstances.

The other big launch that's coming up is Sage Intacct in South Africa. Again, that will go ahead as planned later in the year. But how hard we promote it will depend on the circumstances in South Africa at the time.

Jonathan Anton George Howell ***The Sage Group plc - CFO & Director***

And I could also just add, look, just to call out, the cloud native sort of offering that we've got is growing very fast. It's a 31% growth again this year. It represents 13% now of our total recurring revenue, and we've got ARR there of about GBP 220 million. So that is performing exactly the way that we would like it, and we're beginning to see some payback from the investment that we've made in this area in the past.

Operator

Your next question comes from the line of Michael Briest from UBS.

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

A couple from me as well. Just in terms of the billing cycle, I think as you move more people onto subscription, there's been a move away from -- to the annual upfront support billing as traditionally seen. Can you talk a little bit about how much is on monthly and quarterly? And I guess, in the context of April, where you're talking about a slight increase in churn, I mean, obviously, across 12 months of the year, 1 month is never going to have a meaningful impact, can you just talk about maybe of the proportion of contracts that came up in April? Was there a noticeable increase in churn there? And similarly, on the contracting, even if customers are billed monthly or quarterly, are they sort of legally contracted to 12 months or even longer duration contracts? And then I've just got a follow-up on the resellers.

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

Sure. So I'll hand over to Jonathan. But just a quick -- just from a commercial perspective, always useful to look at these. It's not 100% accurate. But if you look at the small segment and then you look at the medium segment for this purpose, the dynamics are a little bit different. The predominance in the small segment now is monthly. It's -- we typically in the U.K., for example, on both Sage 50 and Sage Accounting, it's typically monthly direct debit. And also, in the small segment, even if it isn't monthly billing, to your second question, we allow 30 days cancellation. Medium segment is slightly different. It tends to be more predominant. So for example, Intacct is pretty much all annual billing. We do very little multiyear contracts. We do some in the medium segment, with X3 and occasion with Intacct. But it isn't something we really push. We go more for annual cycles.

Jonathan, do you want to add some color, particularly around some of what we've seen in April?

Jonathan Anton George Howell ***The Sage Group plc - CFO & Director***

Yes. So look, I mean, very, very much, as Steve said, we have mixed billing arrangements and mixed contract arrangements across our portfolio of different products and across our territories. And it's exactly as Steve has said. What I would just say is that those larger territories where we have predominantly small segment, i.e., Sage 50 on monthly arrangements, we saw an initial small spike in cancellations, but that has very rapidly come back to sort of normal levels of churn. And in the countries that where we have more predominant positioning towards medium segment and longer contracts, we haven't seen much of an impact. If you take it all together, for April, it is only a very slight increase in churn. But again, I just sort of would say this is 1 month in isolation, and clearly, many sort of factors that are outside of our control and with uncertainty. And so therefore, we're certainly not and we're not encouraging you to draw sort of a 6-month or an 18-month projection off the back of those comments on April. But so far, it's performed exactly as we sort of planned once we set out a new COVID-19 environment for the business.

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

Okay. And then just on the sort of route to market. You've got 40,000 resellers, 100,000 accountants as partners. Clearly, the vast majority of those are SMEs themselves. Is there any concern about their viability? If there's no new customers buying, then a reseller is not getting his 40%, 50% cut of revenue. So what are you doing to support them? Or is there a concern that, that could impact your recovery once all this is over?

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

Yes. So we're treating partners really in the same way as we are with customers. And that we're taking a targeted approach, so we're in constant dialogue with the partner network. And as appropriate, we've been supporting them to ensure that we're helping them in the same way that we would a customer.

I think in the longer term, probably what this sort of current environment is going to do is a bit like it will almost certainly accelerate digitization and accelerate people's desire for more flexible tools, and therefore, cloud adoption, et cetera. It's probably also going to accelerate the way that some of the partners, resellers, accountants, et cetera, also need to transform their own businesses, which is obviously already happening. There's obviously already a significant change taking place within accountants, and I suspect we're going to see that accelerate. And our role is to support those partners in the same way we support our customers.

Operator

Your next question comes from the line of Charlie Brennan from Credit Suisse.

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

Great. I'll do 2 as well, if I can. Firstly, can I start with a clarification of your guidance? You said you were optimistic that recurring revenue would remain positive, but you've booked 10% in H1. That sets a pretty low bar for the second half. Are you confident that recurring revenue remains positive in H2?

And then secondly, one of the messages seems to be that as other revenue gets smaller, the group's going to accelerate towards the recurring revenue growth. But some of that recurring revenue growth is directly tied to the shrinkage in other revenue. You're also getting the price uplift of moving people to cloud connected. Where do you think the underlying recurring revenue growth is without those one-off factors?

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

Sure. So on the guidance, when we say recurring revenue, we expect it to be positive. That's based on what we see today. And as I say, there's 2 big unknowns. The first is existing customers. Now we believe that, by and large, where customers continue to trade and continue to exist, that we will continue with our high historical retention rates. The one thing we don't control is business failures. And if our customers are not trading, then obviously, we will see increased churn. And that -- the unpredictability of that is made more tricky because of government intervention. So government intervention is obviously welcomed by our customers. But what we don't know is exactly how long that will last and what the impact will be if and when it's withdrawn and whether it's withdrawn in a transitionary way or whether there's a cliff edge. And if you take the U.K., the Chancellor is obviously trying to avoid a cliff edge, has announced the increased -- has announced the extension of the furlough scheme and with some transitioning and phasing to be figured out. So we've made some assumptions about how that might look. But obviously, they could turn out to be wrong.

New customer acquisition is also a tricky one. I think that people, as they adjust to the new norm, and again, assuming that they're trading and they can afford it, actually, are more likely over time to want to adopt the sort of solutions that we offer. But predicting when that will take place is very tricky. If I look today, actually, inquiry levels, opportunity inquiry levels, particularly in the medium segment, have not gone down, i.e., people are coming and they're exploring, they're doing their research. But of course, at the moment, they're not -- that's not converting. They're not spending their money. And it is very, very difficult for anyone to predict when people will have sufficient confidence to move forward with that. So our best estimate at the moment is that our recurring revenue will grow. But how much, and therefore, how short of our 8% to 9% previous guidance we will be, we just don't know at the moment.

As far as the second part of the question, the trade-off between recurring revenue and other, and therefore, where the underlying growth will come in the longer term, the underlying growth in the longer term or the waves of growth, there's still a fair amount of growth to come from the migration strategy that we've adopted in the U.K. and the U.S. in other countries. So if you look at Jonathan's slide about the future Sage Business Cloud opportunity, there's still a fair amount of revenue to be migrated. But secondly, as we more and more fill out the quadrant, we have the native cloud solutions in both small and medium to go after new customer acquisition. And so whilst our long-term aim remains a renewal rate by value above 100%, so getting growth from our existing customers, it also remains our aim to have strong new customer acquisition machines in both the small and medium, led largely by Sage Business Cloud Accounting in small and by Sage Intacct in medium.

Jonathan Anton George Howell ***The Sage Group plc - CFO & Director***

Can I -- I mean, I could just add to that, the -- you're absolutely right that we carried very strong momentum in ARR from FY '19. So we exited with 12.6% growth in ARR at the end of last financial year, and that was driven by the particularly rapid migration of Sage 50 in Northern Europe and North America, and we called that out at the time. And absolutely, as you expect, in an ARR model, that has given us some good impetus into the first half. But a slowing in ARR growth was always anticipated, because at the beginning of the year, we were guiding to 8% to 9% recurring revenue. And that implied slowing after the very rapid migrations last year is entirely in line with our plan and our expectations and effectively what we guided to. Clearly, that's changed now as we move into the COVID-19 environment.

But just to add a little bit of color. So in the U.K., Sage 50 Payroll cloud connected has been doing significant migrations in the first half and in North America, as I said earlier. Sage 50 in Canada, plenty of migrations too there, 200 in North America. We saw strong growth in the first half from Germany and Central Europe, which is 9% in Iberia at 8% recurring revenue growth. And then you can see the Sage Business Cloud penetration is at 35%. So there's still significant runway left in the migration strategy. So if you take France, for instance, Sage 50 and Sage 200, only about 50% migrated at the moment and further to go in Iberia and others. So there is -- as we said sort of 18 months or so ago, there will be different stages of this migration process as we develop and build the cloud native products, and that's what we've seen. We can see a -- fundamentally in the native cloud products coming in at getting on to 30%.

Operator

Next question comes from the line of Stacy Pollard from JPMorgan.

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

One quick follow-up, just on Slide 21, the GBP 130 million from new customers. I'm not sure if you said it, but could you approximately give the split between reactivations and new customer acquisition? And then a follow-up.

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

Jonathan, do you want to give some color on that?

Jonathan Anton George Howell ***The Sage Group plc - CFO & Director***

So this was in relation to which year are we talking about in...

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

So Slide 21 is -- building the ARR slide, what proportion, reactivation, what proportion, NCA.

Jonathan Anton George Howell ***The Sage Group plc - CFO & Director***

It's a broad spread. It's a broad spread. It would be much more weighted towards NCA in the first half this year than what we saw last year. And just if you were looking at sort of overall across the group, if we're achieving a renewal rate by value of 101%, and we're going -- we're growing recurring revenue at 10%, then clearly, the rest is NCA and reactivation. And in the first half, the predominant element of that was NCA.

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

And I think the other thing to emphasize, just as a reminder when you look at the split, pretty much all the growth in native is new customer acquisition. So obviously, the reactivation is only in connected. And in both the U.S. and the U.K. now, the Sage 50 migration is pretty much done. So there is a little bit of reactivation, but it's not material like it was in previous years. So to Jonathan's point, this is pushing now much more towards NCA.

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

Okay. And just a quick 1, maybe 2 more quickly. I realize it's hard to give guidance. You said margins would be below 23%. But could you give us a range of possibility for that? I mean, perhaps as it relates to growth rates. So say x amount of growth or revenues differential would lead to approximately y margin impact.

And then sorry, my last one is just about the competitive front. Kind of reasons that you're winning or losing with new customers, is that more a function of price, functionality, brand name? And maybe has that -- any of that changed at all during the COVID crisis?

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

Sure. So I'll take that second one first, talk about competitors, and then I'll hand over to Jonathan and he can comment on margin.

On competitors, again, if we look between the small and the medium segment, obviously, different competitors, not really seeing any particular difference in competitor activity. I think -- and when we win or lose, it tends to be, at the moment, around the whole offering. So obviously, the product is important, but so is support, so is the kind of whole experience and relationship. And so -- and we do push on that. I mean, we're very proud of our support capability as well as the functionality of our products. And I think as you move through the coming months, we believe that, that will be a very important ingredient that customers are thinking about. Yes, the product needs to be great and the product needs to work well. But there's a wider experience and a wider relationship, and we think we have very, very strong support, both in the small and medium segment, which, in many territories, differentiates us.

Jonathan, do you want to talk a bit about the margin?

Jonathan Anton George Howell ***The Sage Group plc - CFO & Director***

Yes. I mean, Stacy, I've got -- very glad really from the answer -- the full answer I gave earlier on. That margin is the output of 3 variables: recurring revenue, other revenue, and obviously, the cost-mitigation plan. And as I said, we will be proportionate and sensible. And we will make sure that there is a fair and proper balance between short-term cost mitigation to ensure a sensible margin, whilst at the same time, ensuring that we're going to invest for the long term.

One of the reasons -- the 2 reasons why we cannot be more precise is because of the uncertainties and the factors that's outside of our control. But also, we will dynamically change our cost decisions as we move through the year, and we get further evidence of the impact of the recession and how our business is performing. But what I can say is we understand the needs and importance of that margin, and we will be proportionate and sensible in how much that slips below the original guidance, which we made at the beginning of the year in a pre-COVID environment, of 23%.

Operator

And our next question comes from the line of Paul Kratz from Jefferies.

Paul Kratz ***Jefferies LLC, Research Division - Equity Analyst***

Maybe just 2 questions from me. I think on Sage Intacct, historically, that's been a product that's geared more towards, I guess, service verticals. Could you maybe share with us some of the progress that you have in terms of rolling out modules for manufacturing and maybe some of the construction verticals where, historically, Sage has tended to do quite well, especially in the U.K.?

And maybe in terms of my second question, I mean, is there any additional color you can share in terms of how churn has trended across some of the different verticals, maybe in terms of manufacturing, construction and travel and leisure, and how that compares and contrasts?

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

Sure. So with Sage Intacct, you're quite right, the sweet spot has typically been service industries, non-for-profit, et cetera. And I sort of touched on the fact that we've been doing some work around really clarifying our offerings by industry vertical, and in particular, taking the Intacct offering and then the rest of the offering, including X3 from the rest of Sage. And really ensuring that X3 is completely focused on its -- the areas where it's strong, which typically is manufacturing and complex distribution, and ensuring that we have the right positioning between Intacct to X3.

And increasingly now, we have a number of partners who carry both. So we've been working with the partner network to ensure that they have, as I say, the right solutions for the right verticals. And one of the kind of exciting outcomes from the collaboration between the various teams across the world has been that we, in the U.S., have just launched Sage Intacct Construction. Now we've historically had a very strong position in the U.S. in construction and real estate. We have a sort of separate business unit that focuses on construction real estate, and we have a separate partner network that supports that vertical. And one of the partners, who I spoke to a month or so ago as we were launching Sage Intacct Construction, said to me, this is an absolute game changer. This is by far and away the standout product for this vertical. Now we've only just launched it, but we're very optimistic about that. So we're very much approaching that medium segment with a joined up, integrated, verticalized strategy to ensure that we get the best out of our Intacct offering, but also the best out of our X3, and indeed, the expertise that we have sitting in our 200 and 300 franchise. We have a lot of partners and developers who have deep expertise in the distribution and manufacturing verticals.

Jonathan, do you want to add anything on the question around churn? I mean, obviously, driven by -- I think in the medium segment, we really haven't seen any movement in churn in any of the verticals at this point.

Jonathan Anton George Howell ***The Sage Group plc - CFO & Director***

Yes. I mean, just to reiterate. The impact of 1 month so far has been slight. We have the benefit of the law of large numbers with 3 million customers across both small and medium segment. And as Steve has said, we've seen virtually nothing in the medium segment and a little bit more in the small segment than we would otherwise normally have seen, which varies -- which we've seen vary slightly by territory, but no sort of trend that we can discern at this stage. We would just update you clearly at -- on a regular basis, and the next checkpoint is Q3. And so we'll have to give an update then.

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

Yes. And I think it's worth just emphasizing, Paul, I think, to the earlier question, which I think I was asked by Michael. In the medium segment, it is much more predominantly annual, an annual billing cycle. And so -- even more so than in the small segment, 1 month doesn't tell us very much at all. What we will need to do is build up a record as more of the medium segment subscriptions come up for renewal.

Paul Kratz ***Jefferies LLC, Research Division - Equity Analyst***

Maybe just a follow-up to my first question. I mean, now that you're taking a bit more of a verticalized strategy in the medium segment, is there an effort or a push, I guess, to try to apply that to the small segment where there might be some value-add for some of your larger small customers? And could you maybe speak also to the extent that, that is actually added as a -- or become a competitive moat, I guess, some against the likes of Xero and QuickBooks?

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

Sure. So I think it is -- our approach is much more developed in the medium segment where not just the product, but the expertise in the way that you support a customer doesn't need -- it doesn't need to be more verticalized. A non-for-profit or a retail customer or a manufacturing customer expects the provider to understand their industry.

In the small segment, that's less prevalent, but it is increasing. And it's increasing because, apart from anything else, through the Marketplace, ISVs and partners are getting more adept at producing point solutions which suit particular industry types. So I think you will always -- Sage Business Cloud Accounting works for small businesses in the same way that any of our competitors' products do as well, and you won't really see -- I don't think those products in themselves needing to deliver vertical modules. But what you will see is increasing solutions through Sage Business Cloud through the Marketplace. And through us delivering in the digital environment, you will see us delivering more and more services, which are focused on particular industry types.

I think we probably have time for one more question.

Operator

Yes. And that question comes from the line of James Goodman from Barclays.

James Arthur Goodman ***Barclays Bank PLC, Research Division - Research Analyst***

Just looking back at the H1 margin, actually. You guided to 23% last year. And normally, we'd expect the first half to be a bit weaker. You had some effects from COVID at the end of the period. And then you've actually excluded this additional bad debt expense -- or rather incurred it. So if we excluded it, you'd be, I think, above the full year original margin guidance. So my question is, were you running ahead of margin expectations in the first half? And if so, why?

And then just a second question, partly clarification. Just around the commentary you've given of the new customer acquisition halving in April. And to be honest, it's reasonably impressive, I think, during that peak disruptive month to see that level of order intake at all. But is that a value-based sort of comment? Is that how we can translate that to that bridge between net renewal and revenue growth? And there were some comments this morning also around no price rises for customers, and if that's the case, presumably, that adds something of an effect on top of the new customer acquisition effect.

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

Sure. I'll take that second one, and then I'll hand over to Jonathan to talk about margin.

The comment on new customer acquisition in April, yes, is value. And as we are saying, look, we would -- we're not -- we don't want to read too much into it. It's -- I think some of it is just a momentum of pipeline that's continued. But it is encouraging that it was at that sort of level, but I just don't think we should read too much into it.

On the price rises, we had put some price rises through in the first half, modest. We had some intended price rises in the -- sort of in transition which we have suspended. So we won't be putting through any price rises in the second half. That does have an impact. It's not hugely material, but it obviously does have an impact, and we will not be putting prices up in the remainder of the financial year.

Jonathan, do you want to comment on the margin question?

Jonathan Anton George Howell ***The Sage Group plc - CFO & Director***

Yes. On margins, as you can see, we came in at 22.8%. We guided for around 23% for the full year previously. The GBP 13 million additional bad debt is as a result of COVID, and that is about a 50% increase on the provision that we would have carried otherwise, which was about GBP 25 million. So it's a 50% increase on that. We think that's prudent and appropriate at this stage.

But then going the other way, there have been some savings in the accrual for variable costs in the first half, and that would include things like bonus and share-based payments and things like that. So if you take the full impacts of all of those things as a result of the new environment that we're moving into, the first half margin would have been about 23%, in fact. So we were running according to plan of the 23% margin in the first half with a similar margin in the second half before we moved into this new environment at the end of March.

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

Great. Thanks. So as I say, we're out of time now. So thanks, everyone, for the questions. Really appreciate it. And thanks again for joining us this morning.

So just, look, to recap. We have had a very good first half. We are optimistic about the future, and not actually just the future for Sage, but for our customers, colleagues and stakeholders. And we are well placed to navigate the near term.

So thanks again for joining us, and I do hope that we'll be able to see you all in person sometime soon. Thank you.

Operator

That does conclude our conference for today. Thank you for participating. You may all disconnect. Speakers, please remain on the line.