Sage Group Plc Q1 Trading Update

Wednesday, 26th January 2022

Introduction & Business and Financial Overview

Jonathan Howell

CFO, Sage Group

Thank you very much. Good morning, everyone, and welcome to Sage's Q1 Trading Update. First, I'll run through the key numbers and the performance of the business. And after that, we can open for Q&A. Just as a reminder, all numbers in the trading statement are on an organic basis.

Sage has made a strong start to the year with accelerated growth, in line with expectations, as we focus on our strategy to be the trusted network for small and mid-sized businesses. Recurring revenue was up by 8% to £429 million. This was driven by strong growth in Sage Business Cloud of 21% to £280 million.

With continued strength in new customer acquisition, software subscription revenue grew by 13% to £336 million. As a result, subscription penetration is now at 73%, up from 68% this time last year.

Regionally, we saw growth accelerate across the Group. North America grew recurring revenue by 11% with further strength in Sage Intacct, together with a good performance in cloud connected. In Northern Europe, recurring revenue grew by 7%. This reflects an acceleration in our cloud native solutions, including Sage Accounting, alongside growing momentum in Sage Intacct.

And in the international region, recurring revenue grew by 5%, driven by growth across Sage Business Cloud. This was supported by further progress in migrations.

Looking at the portfolio view, recurring revenue for the future Sage Business Cloud opportunity increased by 10% to £394 million. The pace of growth in both cloud native and cloud connected continues to be significantly ahead of the Group as a whole. Cloud native revenue saw a strong growth of 44% to £90 million. This was mainly driven by new customer acquisition across the portfolio, in particular, Sage Intacct, Sage People and Sage Accounting.

And cloud connected continues to demonstrate strong growth through new customer acquisition, together with continued migrations, particularly in international. As a result, Sage Business Cloud penetration has increased to 71%. This is up from 65% a year ago with more customers able to connect to our digital network.

And finally, recurring revenue in the non-Sage Business Cloud portfolio was down by 15%, in line with expectations.

Just touching on other revenue. This decreased by 22% to £29 million, in line with our strategy. And as a result, total revenue grew by 5% to £458 million.

Finishing on the outlook. With first quarter growth in line with plan, we reiterate our guidance for the full year. Recurring revenue growth in the region of 8% to 9%. Other revenue will continue to decline in line with strategy. And we also expect organic operating margin to trend upwards in FY'22 and beyond.

And so in summary, we've made a strong start to the year. Growth is accelerating, in line with expectations, as we execute on our strategy and focus on scaling the Group.

Thank you. And now let's open for questions.

Q&A

Operator: Thank you. We will now begin the question and answer session. To ask a question, you will need to press star one on your telephone. To withdraw your question, please press the pound key. Please standby while we compile the Q&A queue. And the first question comes from the line of George Webb from Morgan Stanley. Please go ahead.

George Webb (Morgan Stanley): Morning, Jonathan. Just one question from my side. Could you talk a little bit about how ARR trended in Q1, and how that kind of informs what we should expect on the shape of organic recurring revenue growth as we move through the rest of the year? Thank you.

Jonathan Howell: Yes. I mean, very good question. The ARR growth that we reported at the end of last year, FY'21, for the full year was 8%. We just reported recurring revenue for Q1 this morning of 8% growth, and that compares with 7% growth that we saw in Q4 of last year.

And so, therefore, that clearly implies that the growth rate of ARR has increased since the year-end and we've seen some progression during Q1. And just to give you sort of some feeling around that, it's about 2% sequential growth that we've seen in Q1 this year of – in terms of ARR, which is in line with the 2% or so that we saw at Q4 at the end of last year. So good progress in ARR, and it really sort of underpins our expectations for the full year.

Operator: Thank you. Next question comes from the line of James Goodman from Barclays. Please go ahead.

James Goodman (Barclays): Yes, morning. Thanks very much. Maybe switching over to cost side of the business a little bit. Clearly, we had the restructuring of some pockets of headcount at the end of the last fiscal year. Just wondering if you could update us really in terms of how the reinvestment plans are going there and maybe some commentary between hiring success, digital marketing investment, anything you can say there about the hiring environment and wage inflation would be helpful as we think about the cost phasing through the year? Thank you.

Jonathan Howell: Yes. James, thank you for the question. Just to remind ourselves that at the end of last year, we announced a restructuring, which was an effect the removal of 800 roles from the organisation. And we were very clear at that stage that that was going to be 100% replaced through further investments in the business, some of that in heads and some of that in digital marketing spend and brand investment.

That generated an exceptional charge last year-end of about £67 million, which we reported at the year-end. And the programme of removing those roles and then reinvesting is running according to plan at the Q1 stage as we move through the year.

The hiring environment is a little harder. We've seen slightly higher attrition, but none of that is material in terms of our ability to execute at this stage. And so, in terms of the cost progression through the year, it's very much as we sort of anticipated when we started this financial year.

And just to remind everybody, we reported a margin at the end of last year FY'21 of 19.3%. And that was driven by increased levels of investment in sales and marketing and products. And at year-end stage, we guided for FY'22 that the margin would trend upwards during FY'22 and beyond. And that's exactly what we've seen during the first quarter. And so, we're very much on track with our plans in reinvesting and maintaining that guidance.

The only thing that I would add, and I did say also at the year-end last year on the earnings call, was that we do reserve the right to dynamically accelerate or de-accelerate the level of investment during the course of the year. But nonetheless, and importantly, that does not change our overall guidance. Thank you, James.

James Goodman: Thanks a lot.

Operator: Thank you. Next question comes from the line Ben Castillo from BNP Paribas Exane. Please go ahead.

Ben Castillo-Bernaus (Exane BNP Paribas): Good morning. Thanks very much for taking my question. Can I ask around capital allocation, use of cash? If I'm not mistaken, I believe the second buyback tranche has come to an end now that was announced back in September. How we should we think about that going forward as you balance M&A? If you can talk about what sort of targets you may be looking at over time to indeed continued return to shareholders? Thank you.

Jonathan Howell: Ben, thanks very much for the question. Yes, as you quite rightly point out, for much of last financial year and indeed during the first quarter, we were conducting a share buyback programme. We've completed that now. There were two tranches of £300 million each and we've now just completed this week the full £600 million.

That buyback was very clearly flagged as being surplus capital at that stage. And indeed, at least £500 million of that was generated in the disposal programme that we've been doing over the last two years. And so that has come to the end now. And now at this stage, we are really focusing on investing in the business, notwithstanding the fact that we're going to increase the margin but also doing appropriate M&A. And I think the Brightpearl acquisition is a good example of that.

The Brightpearl acquisition which we announced pre-Christmas really enables us to move into a new vertical, e-commerce and retail digital marketing. It also gives us the opportunity to expand the Intacct verticals that we're operating in and the Intacct user base.

And lastly, and probably very importantly, is it also enables us to add new customers and information and transactions going through the Sage digital network. That is exactly the type of transaction that we want to keep examining in future quarters and years.

Just in terms of sort of surplus capital, we exited last year with a net debt at £200 million. That's 0.6 times net debt to EBITDA. Just need to remind everybody that since the FY'21 year-end we've done about £200 million worth share buyback, completed, and we've also completed on the Brightpearl transaction, which is £225 million.

So, we're now moving back towards or into the target range of net debt to EBITDA that we have of 1 to 2. So very much on track and making sure that we invest appropriately where we have the opportunity. Thank you, Ben.

Ben Castillo-Bernaus: Thanks a lot.

Operator: Thank you. Next question comes from the line of Michael Briest from UBS. Please go ahead.

Michael Briest (UBS): Yes. Thanks. Good morning. Actually, I mean, you've normally given net debt figure, I was just curious why that wasn't there. But can you say something about churn rates? And then more structurally, as we think about the business evolving, 20% of the business is cloud native now. Can you describe the sort of margin profile either at gross margin and then operating margin might be difficult. But just help us understand how as you grow further in cloud native, that might affect gross margins overall profitability?

Jonathan Howell: Yes, so I think I might have sort of three points there. Just in terms of the financial position, we introduce reporting on the financial position as we moved into the COVID pandemic about 18 months or so ago. We didn't do that previously on a Q1 and Q3 basis.

And as now the business is sort of coming through towards the end of the COVID environment, we're not giving a quarterly update on the leverage and net debt position.

In terms of churn, we reported at last year-end that we had continued to see a decline, and indeed that we were now sort of last year, the FY'21 year-end, at a level that was lower than the pre-COVID environment. And what I can say is at the Q1 stage that is exactly the same. So, we are now operating at probably the lowest that we've been operating in terms of churn. And that takes us back to below where we were before the COVID pandemic.

In terms of margin profile, we – as we are now getting the right products to market with the right marketing strategy behind it in terms of digital and through the partner channel, we believe that we can maintain these more elevated levels of growth, whilst at the same time gradually improving margin. And that's exactly what we've seen in Q1. We're reiterating firmly our guidance for the full year.

And we believe that as we get a scalable cloud native product base, a scalable cloud native platform and the added benefits of the Sage digital network that that will enable us to continue to drive revenue growth at a rate in advance of cost growth, whist being able to continue to maintain not only for the near-term but also for the longer term. So, at this stage, it's very much as you – as we've guided for this year.

Michael Briest: Okay. Thank you.

Operator: Thank you. Next question comes from the line of Will Wallis from Numis. Please go ahead.

Will Wallis (Numis): Morning. I want to ask a question on pricing first and then dig in a little bit more on the ARR growth. Firstly, on pricing. I think you talked about the potential to increase prices a bit as we go through this year. What do you think – well, can give us an update on that, including update on when the – timing of when that will actually have an effect on your ARR growth as you go through FY'22? And then the second question in relation to the sequential ARR growth of about 2%. I think you had said towards the end of last year that you've done a pretty good job – at the end of last year of converting the pipeline, which was obviously a bit of headwind to ARR growth in Q1. Was that actually the case? And as a sort of second part to that, do you think of any seasonality in terms of quarterly ARR growth that we should be expecting sort of on a normal basis? Obviously, there are these external factors as well.

Jonathan Howell: Yes, first of all, in terms of pricing. The – we have a pricing strategy that is based upon the product offering that we're giving to our customer base and the ability of that products that we're offering is to improve efficiencies for our small and medium-sized businesses. And we take into account other factors like inflation.

And if you recall 18 months or so ago when we entered the pandemic, we very clearly set out our stall and said that we would not be putting through any price increases that we wanted to work with our customer base during a considerable period of economic uncertainty for small and midsized businesses.

We have done that. And at the last year-end, FY'21, we said that as we moved into FY'22, we would now begin to introduce price increases. We had an internal plan. That plan was based on a inflation environment, which we are seeing now. And we're executing on that plan of price increases only where we see there's a fair value exchange between our customers and ourselves. That will run for the full course of this year, and we'll begin to improve revenue during the course of the second half.

But we will always keep it under review. It's not saying that we have plans to change what we set out to do, but we will always keep it under review.

And then in terms of ARR, it was – as you said, it was good strong sequential growth of 2% in Q1, 2% in Q4 last year. We are able to convert the pipeline at the pace that we believe we should be. And much of that NCA is being driven by Intacct and also through the partner channel there as well.

We – there is no particular seasonality. Obviously, during the summer, it's sort of a bit quieter around—the Christmas period is a little bit quieter. But quarter by quarter, there should be no particular emphasis on how it should be phased during the course of the year. The increase that we are seeing now in ARR really sets us up well to maintain high single-digit growth during the second half of the year, which is against these tougher comparators that we've got for Q3 and Q4. Don't forget that the revenue growth really kicked up in the second half of last year.

Will Wallis: Thank you.

Operator: Thank you. Next question comes from the Stacy Pollard from JP Morgan. Please go ahead.

Stacy Pollard (JP Morgan): Hi. Thank you. Two questions for me. You seem to be doing well in new customer acquisition. Do you think this is strong market demand or that you're particularly stronger against the competition? And second question. Do you think you can boost international growth up to Group level, or is that structurally just likely to be a little bit slower than North America and Northern Europe for a few years?

Jonathan Howell: The strong growth that we're seeing in cloud native, in particular, which is the backbone of growth, it grew at 44% in Q1 off the back of our core products, Sage Intacct, Sage People and Sage Accounting. That's driven by having absolutely the right products with the right additional modules in the market. And we believe are as good as, if not better than our competitors.

There is also good demand always for accounting software, HR and payroll software and also our digital network. This provides real efficiencies for small and medium-sized businesses. And those trends we believe are deep seated and are being supported by the increased spend that we took the decision last year and the year before to invest more through the P&L in sales and marketing and product.

And I think what we saw in the second half of last year and what we've seen in Q1 of this year bears testament to that increased investment.

On international, it is growing at about 4% or 5% at the moment. We – the important thing to understand is that we have fewer cloud native products in this region. And we are still working our way through the migration programme to cloud connected. And that is important across the whole Group. As you can see, Sage Business Cloud now is at 71% penetration. That's up from 65% a year ago.

And to finish that off is really the focus is on the international region. And so, therefore the focus there is to migrate Sage 50, Sage 200 from on-premise into cloud connected. Nonetheless, where we are introducing cloud native products there, we are beginning to see contraction. So, I think it will come up to the rest of the Group's growth rates but that is a process that is going to take some time and will only really move forward at pace when we got the right and full cloud native products set in place for that region.

Stacy Pollard: Thank you.

Operator: Thank you. Next question comes from the line of Paul Kratz from Jefferies. Please go ahead.

Paul Kratz (Jefferies): Hi. Thank you very much everyone for taking me on. Just two questions from my end. When I listened to your commentary around renewal rates and the development of ARR in the period, it sounds like quarter-on-quarter there was actually a slight deceleration in new customer acquisition. So, it would be good to understand what are the drivers of that deceleration? And how should we think then new customer acquisition throughout the year? The second question that I then had is you mentioned then price increases but also very high gross retention. Do you think with the price increases that you're pushing through that we should not see any delta to downside on your gross retention? And basically, that would mean that your net retention rate should actually trend up throughout the year? Thanks.

Jonathan Howell: I mean, in terms of gross retention, we – as I say, any price increases that we put through is based upon the product offering that we've got in market, the effectiveness and the efficiency with which our customers can deploy that. And so therefore, it's based on the sort of fair value exchange between us and our customers. The price increases that will be – that have been put in place during the course of this year, we believe will not have a material impact either way on our sort of gross retention rates or gross churn rates.

In terms of the sort of the growth, I mean, cloud native, we've seen sequential growth across the piece of 2% and it was 2% at Q4 last year. And in cloud native, we've seen an acceleration. So, we are not seeing, in any way, a material deceleration of growth in Q1. It's only Q1. We've got a full year.

As I've said earlier on the call, we are running into periods of sort of tougher comparators, but we do you feel though confident that the guidance of 8% to 9% is something that is our fair and best estimates at this stage. So no, we wouldn't say that there's a deceleration at this stage.

Paul Kratz: Okay. That's very clear. Thank you.

Jonathan Howell: Thank you.

Operator: Thank you. Next question comes from the line of Gautam Pillai from Goldman Sachs. Please go ahead.

Gautam Pillai (Goldman Sachs): Great. Thanks for taking my questions. Jonathan, can you please comment if you saw any benefit of making tax digital in the UK in the quarter, or expect anything in Q2? And second question on the cost side, any comment on any investment zone go-to market for Brightpearl in '22? If I recall correctly, Brightpearl is at a breakeven level for EBITDA. Anything we should keep in mind in modelling margins in this context? Thank you.

Jonathan Howell: Yes. Brightpearl, the acquisition of Brightpearl and the completion of Brightpearl really hasn't, in any way, changed the guidance. I mean, just to remind everybody, we've got – when we announced the acquisition pre-Christmas, it had £20 million of recurring revenue for calendar year '21. It was growing at about 50% at that stage on a breakeven margin basis.

It won't be incorporated in our organic numbers this year. It will be incorporated in our underlying and statutory numbers. And just to give you a feel, if you were just very simply to take a pro forma adjustment for a full year of Brightpearl and layer that onto the Sage Group, you would see a slight enhancement in growth rates of the Group, 30 to 40 basis points, and you would see a very slight but not material dilution in total margin.

So really not material or margin to answer your question, and certainly isn't impacting or nor will it impact the guidance that we're giving for the full year.

Sorry, and your other question was around – making tax digital.

Gautam Pillai: Yeah.

Jonathan Howell: Yes. It will come to play during the course of this year. It will not have – given the nature of the changes, it will not have a material impact on our numbers, given our customer base, given the segment that we are in, which is different from making tax digital one, where if you recall had a very, very significant impact.

We will see a little bit of benefit but not to the extent that we saw two years ago. And again, nothing in that is changing or impacting our guidance.

Gautam Pillai: Got it. Thank you so much.

Jonathan Howell: Thank you.

Operator: Thank you. That's all the time we have for questions today. I would now like to hand over back to Mr Howell for final remarks.

Jonathan Howell: Just like to say thank you very much indeed for your interest, for your questions and your continuing interest in Sage. Needless to say, if you have any further questions, do please contact James and the team during the course of today or over the ensuring weeks. Thanks very much indeed. Goodbye.

Operator: That does conclude our conference for today. Thank you for participating. You may all disconnect.

[END OF TRANSCRIPT]