Sage Q1 2023 Trading Update

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Introduction

Jonathan Howell

CFO, Sage Group

Thank you, very much, and good morning, everyone. And welcome to Sage's Q1 trading update. I'll briefly run through the key numbers and the performance of the business. And after that, we can open for Q&A. And just to remind you that all the numbers in the trading statements are now reported on an underlying basis, unless otherwise stated.

So on to the performance of the business. I'm pleased to say that Sage has made a strong start to the year with performance in line with expectations. Recurring revenue was up by 12% to £517 million. This was driven by strong growth in Sage Business Cloud of 31% to £390 million, with continuing good levels of growth from both new and existing customers.

Subscription revenue increased by 18% to £422 million. And as a result, subscription penetration is now at 78%, up from 73% this time last year. Regionally, North America grew recurring revenue by 18% to £235 million, with continuing strength in Sage Intacct, together with a good performance in cloud connected.

In the UKIA region, recurring revenue grew by 12% to £151 million. This was driven by continued success in cloud native solutions, including Sage Intacct and Sage Accounting, supported by growth in Sage 50 cloud connected.

And in Europe, recurring revenue grew by 3% to £131 million, with growth across Sage Business Cloud, partly offset by the Swiss disposal in Q1 last year. Organic recurring revenue growth in Europe, which excludes the disposal, was 6%.

Looking now at the portfolio view. Recurring revenue for the future Sage Business Cloud opportunity increased by 14% to £479 million. Cloud native revenue saw strong growth of 45% to £141 million. This mainly reflects continuing good levels, new customer acquisition, together with the impact of acquisitions in FY'22.

And cloud connected has also continued to grow strongly, driven by existing and new customers, together with migrations to Sage Business Cloud. As a result, Sage Business Cloud penetration has increased to 81%, up from 71% last year, with more customers able to connect to Sage's digital network.

Finally, recurring revenue in the non-Sage Business Cloud portfolio was unchanged at £38 million. And just touching on other revenue, this decreased by 29% to £23 million in line with our strategy. And as a result, total revenue was £540 million, which represents underlying growth of 10% and organic growth of 9%.

Finishing on the outlook. With first quarter growth in line with plan, we reiterate our guidance for the full year. Organic recurring revenue growth is expected to be ahead of that reported for FY'22. Other revenue will continue to decline in line with strategy. And we also expect operating margins to increase in FY'23 and beyond.

And so, in summary, we've made a strong start to the year as we continue to execute on our strategy and focus on efficiently scaling the Group.

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

Q&A

Operator: Thank you. As a reminder, to ask a question, you will need to press star one-one on your telephone keypad and wait for a name to be announced. Please stand by while we compile the Q&A roster. This will take a few moments. Now we're going to take our first question. Just give us a moment. The first question comes from line of Adam Wood from Morgan Stanley. Your line is open. Please ask your question.

Adam Wood (Morgan Stanley): Hi. Good morning, Jonathan. Thanks for taking the question. Congratulations on a good start to the year. Mine was just on the ARR side of the business. I wondered if you could just give us a little bit of help on how that's trended through the first quarter, and then maybe specifically whether you've been able to broadly sustain the growth that you saw in ARR in the fourth quarter, which was 12% if memory serves? Thank you.

Jonathan Howell: Adam, yes, thanks very much for the question. As you know, we only report ARR formerly at half year and full year. But we exited FY'22, as you said, with strong ARR growth of around 12%. And since then, in Q1, we've seen sequential growth of just around 2%. And that, therefore, is line with the – in line with the growth that we saw in Q1 last year. And it's also very consistent with the plans that we had for the business at the beginning of the year. And it also really underpins the full year recurring revenue guidance that we've given that we do expect organic recurring revenue growth to be ahead of that that we reported in the full year last year.

So that's the trends that we're seeing at the moment. Clearly, we'll update the market at the half year and beyond. But it's a good start to the year.

Adam Wood: Perfect. Thank you very much.

Operator: Thank you. Now we're going to take our next question. And the question comes from the line of James Goodman from Barclays. Your line is open. Please ask your question.

James Goodman (Barclays): Yes, morning. Thank you. Firstly, a follow up, I suppose on the sequential ARR. Jonathan, thanks for that. 2% you said in the quarter. I think it was 3.5% sequentially also in the fourth quarter last year. Is that just purely sort of quarterly volatility that's accounting for the slight slowdown there. I'm thinking that you should have some pricing tailwind? I think you said 4.5% to 5% sort of annualised pricing tailwind for this year? Or are you seeing some signs of macro impact in areas like the UK in new customer acquisition? So if you could talk about some of the moving parts within that in a bit more detail, that would be very helpful. And then I've got a follow up. Thank you.

Jonathan Howell: Thanks, James. Look, first of all, in terms of ARR, we – if you look at our ARR progression, we don't normally have any strong seasonality in the business. The only exception to that is sometimes towards the end of Q1 around the holiday period in December, there is a slight slowing of volume and transaction flow. But otherwise, I wouldn't read too much into some sort of particular seasonal trends in the numbers that you're seeing.

In terms of pricing, good question. We talked, as you know, last year, on a few occasions about this. Across the portfolio last year, we put through about 4-5% price increase in average, where we thought it was appropriate and where we saw a fair value exchange with our customers for the services that we provide.

As we move into this year, we – our plan for this year is exactly the same, about 4-5% across the whole portfolio. And so that's very consistent with what we did last year.

And then lastly, in terms of macro impact, we have not seen any impact on the business in Q1. We are very mindful of the macroeconomic conditions out there across most of our territories. But so far, we haven't seen that. And I think it's just important to say that there is resilience in this business. We have a business that is 95% recurring revenue. We also have big geographical spread. And therefore, for instance, the US provides 40% of our revenue. And the macroeconomic conditions there are probably a little bit better than other parts of, say, Europe.

And then lastly, we are providing a mission-critical service and products and capabilities to our customer base. It enables them to run the business, it gives them resilience, it also drives digitisation and efficiency. So notwithstanding the fact that we are mindful of the macroeconomic environment, there is resilience in our core business. I hope that’s helpful.

James Goodman: Yeah, very helpful. Thank you. I'll leave it there. Thanks. It was very comprehensive.

Operator: Thank you. Now we're going to take our next question. And the question comes from line of Kathinka de Kuyper from UBS. Your line is open. Please ask your question.

Kathinka de Kuyper (UBS): Hi. Thank you very much for taking my question. Maybe just looking at the cost side of things, obviously, you're putting through price increases of 4-5%. But what are you experiencing yourself in terms of wage inflation? And are you still comfortable with where consensus sits at around 90 bps of improvement versus 2022 for the full year? Thank you.

Jonathan Howell: So yes, just in terms of the cost impact, first of all, we have a global business, as you know, and therefore we have different economic impacts on different parts of our business at any given time. I think those who understand, they'd be inflationary impact. We have – about two thirds of our cost base is people and people-related costs. And therefore, at the beginning of this year, we've set out a plan. We’ve put through what we consider to be appropriate increases for our colleagues around the world. And therefore, we have good visibility and certainty about two thirds of our cost base.

The – there are inflationary impacts on other parts of our cost base, but in aggregate, they're not material. And so therefore, my message is just we need to just focus on the people and people related costs. We have good cost discipline, as you know. We have good visibility, as I've just described on much of our cost base. And therefore, we are confident in the guidance that we've given that we will not only be able to accelerate growth during the year in recurring revenue, but we will also be able to live a margin expansion during FY’23 and beyond.

In terms of what we've achieved, last year we increased the margin during the course of the year. We exited with a margin of around 20%. We anticipate that we can continue to extend that period of margin expansion. We are comfortable at the moment with where consensus is. And we think that is the right place to settle at this stage in the year. Thank you.

Operator: Thank you. Now we're going to take our next question. And the next question comes from line of Balajee Tirupati from Citi. Your line is open. Please ask your question.

Balajee Tirupati (Citi): Thank you. Good morning, Jonathan. Thanks for taking my questions. Two, if I may. First, could you talk about the competitive dynamics, particularly in the small business segment? With a potential slowing of growth and extension of Making Tax Digital timeline, do you see risk of increased competitive intensity on price increase? And then I have a follow up as well?

Jonathan Howell: Yes. So look, in terms of the competitive dynamic across our portfolio, it's very much unchanged. We haven't seen a change in the competitive environment, nor particularly in the products that have been released, nor indeed and our core territories and core products in terms of pricing. And we – I think the growth that we are achieving is as a result of the investment programmes that we've had over the last two to three years. And as you know, that investment has gone into sales and marketing, with a significant increase in the marketing spend over the last two to three years and also in products.

And I think bringing those two together, driving greater focus and efficiency on fewer cloud native products in our core territories is what's driving this growth.

And a very good question on Making Tax Digital. Thank you. If you recall, back in FY'19, the first phase of Making Tax Digital was in relation to larger companies, and did have a material impact on our results in FY'19 in the UK, and therefore impacting also the overall Group results.

In terms of our planning for the second phase of Making Tax Digital, we were very cognisant of the fact that related to smaller companies, and would be spread over a more extended period of time. And so, therefore, in our planning for this year and thereafter, it was going to have a really a non-material impact in terms of the growth rates that we want to achieve in the UK. And so, therefore, although it's disappointing for our customers that Making Tax Digital 2 has effectively been deferred, many of our customers want to digitise their tax submissions and want to make better and more efficient, seamless process.

In terms of the impact upon us, as an organisation at Sage, it's – there's no material impact. Thank you. I hope that was helpful.

Balajee Tirupati: This is helpful. And if I may ask a follow up question.

Jonathan Howell: Yes.

Balajee Tirupati: Just could you talk a bit about Intacct outside of the US and also plans around Sage Accounting expansion?

Jonathan Howell: Yes. Sage – as you know, the bedrock of the Sage Intacct portfolio and customer base is the US where it originated. Two years or so ago, we introduced Intacct into the UK and South Africa. Those numbers back then two years ago were obviously non-material and it was early days. The pickup has been very good. The partner channel in the UK have really taken hold of this product. They like it. They are identifying customers for whom it's giving real benefits. And we're seeing good acceleration in the UK and also South Africa, in Sage Intacct.

The other thing about Sage Intacct to bear in mind is we've launched Sage Intacct right at the end of last year in France. We've got Sage Intacct manufacturing now in France as well. And we've got Sage Active in France. Those are all our state-of-the-art best cloud native products, which are going into continental Europe for the first time. And so that, again, gives us confidence about the longevity of the growth that we can achieve in the cloud native portfolio. Thank you.

Balajee Tirupati: Thanks a lot.

Operator: Thank you. Now we're going to take our next question. And the next question comes from line of Kai Korschelt from Canaccord Genuity. Your line is open. Please ask your question.

Kai Korschelt (Canaccord Genuity): Yeah, good morning. Thanks for letting me ask the question. I just had a quick one on the difference in growth rates between the US and Europe. Obviously, double digits in the US. And I think Intuit, QuickBooks also grew more than 20% in the US as well. So I'm just wondering, typically, the America – the US are sort of ahead on digital transformation. And so, by definition, would that imply that at some stage, you would expect a similar acceleration in Europe? Or do you think it's more of a sort of reflection of the economic growth at the moment? So just wondering kind of your thoughts on that. Thank you.

Jonathan Howell: Yeah, so I think there are two things that drive the – as far as we're concerned, the standout growth that we're seeing in North America, part of it is the product set that we've got, and where we have Sage Intacct now, growing at over 30% in North America, that really drives an expansion of the go-to-market, the expansion of the marketing spend, and really engages the channel.

And so that is a core underpin of the growth trajectory that we're seeing in North America. So it’s good new customer acquisition and very good renewal rate by value, up around 108%, 110% in some instances in that product base.

The other reason is that the move to cloud-enabled, digitised services for accounting, payroll, back-office capabilities, has always been advanced in the US. And that has just accelerated and built as a geography over the last two to three years and certainly during lockdown, and you can see that in the results of other major US software competitors.

In Europe, to your question, as you can see on an underlying basis, it grew 3%, on an organic basis, it grew at 6%. We're in a slightly different position. As I've just mentioned, we are now rolling out these cloud native products really for the first time in continental Europe over the last two to three years. That will take a little bit of time for that momentum to grow. And also, there needs to be a readiness and an awareness and a willingness to adopt these new products in part from the customer base, but also to make sure that our partner channel is also fully engaged. So there is a little bit of a – there's a bit of a time lag there that one would expect. Thank you.

Kai Korschelt: Thank you. And – sorry, can I just say – just by definition then is there potentially an internal expectation without issuing a new guidance that perhaps at some point over the next couple of years, growth in Europe could accelerate in a sort of similar fashion than it has in North America, just because of that sort of slight lag in cloud adoption?

Jonathan Howell: Yeah. The – as you just said, we're not here to be sort of issuing guidance by geography over a three-year period. But I think where – we have now got a very broad product set. We've got Sage 50, Sage 200, cloud connected across a lot of that base. We're supplementing that, just as we've done with these cloud native products. And that is exactly the story of development of Sage, first of all, in North America, which is sales growing at 18%. And then secondly, a few years behind came the UK. And you can see that that's growing at 12%.

And so we are hopeful that this broadens customer proposition that we have, and dedicated marketing spend will sort of improve performance across continental Europe. I hope that helps.

Kai Korschelt: Yes, absolutely. Thank you very much.

Operator: Thank you. Now we're going to take our next question. Please stand by. And the next question comes from the line of Frederic Boulan from Bank of America. Your line is open. Please ask your question.

Frederic Boulan (Bank of America): Hi. Good morning, Jonathan. If we can follow up on the product area, if you can give us an update on the roadmap for '23 in terms of major launches we should expect, particularly in Europe to complement the current offering? And on the US, any update on the marketing requirements you need to push Intacct further and through the win the awareness of Sage versus competition? Thank you.

Jonathan Howell: Yeah. Just in terms of product roadmap, the real push that we've had in a major product development were those ones that I've mentioned in continental Europe, really to fill a very important gap in our product suite. So that has been the main development. I think other things that I would point to that are sort of coming on stream and helping us during the course of this year, the acquisitions that we did last year: Brightpearl, Futrli and lockstep. They were done in Q2, Q3, and Q4, respectively.

So embedding those, getting the capabilities and functionality of those products in front of our very, very broad customer base, particularly in North American and UK, is a real priority. So that's the sort of the product focus at the moment. And clearly, we'll update you on any major launches.

In terms of North America, the important thing to understand is we are now – we've now shifted, very significant spend to marketing over the last two to three years. And we have now over 40% of recurring revenue is the marketing spend. The sales and marketing spend is been at about 40% of recurring revenue. That's a high level of spend, which we want to continue to do.

I don't think in that segment, in the medium segment, that we lack brand visibility or product knowledge. We have one or two important competitors there. We're very, very comfortable with our win rate that we achieve in that market.

Frederic Boulan: Thank you very much.

Operator: Thank you. At this time, now we would like to take our last question. And the last question comes from the line of Charles Brennan from Jefferies. Your line is open. Please ask your question.

Charles Brennan (Jefferies): Hi. Good morning, Jonathan. Thanks for squeezing me in. I think I asked you something similar last quarter, but I'll try again. In the background it feels like we've seen an ongoing level of press coverage referring to you becoming more proactive in shifting customers to subscription. Ultimately, that's obviously a good thing. But can you just comment on whether you've seen any uptick in customer resistance? Or have you seen any change in churn rates as people are shifting from an on-premise solution to a subscription solution? Thank you.

Jonathan Howell: Yes. Charles, thanks very much. A good question. Thank you. The – there has been some press comments as you mentioned. The – this relates to a very small number of Sage 50 customers in the UK. We – it relates to those customers that still are on a on-premise licence arrangement. We have had a five-year migration programme now for Sage 50 customers to move to either Sage 50 cloud connected, or indeed cloud native, if they so wish.

At this stage now, we're now moving all customers into those environments, principally because the version that is being used is really doesn't offer the full product capability, reliability and resilience, and indeed data security that we would expect of a Sage customer. So that's what you're referencing. It's the last elements of this five-year migration.

Obviously, we're doing it carefully and ensuring that all customers have an opportunity to understand what we're doing and how it would benefit them. And as I say, we're just getting to this end stage now after a five-year migration of Sage 50 in the UK. I hope that helps. Thank you.

Charles Brennan: Are you able to size it for us in terms of how many customers – how many Sage 50 customers you've got left in this bucket? I assume after five years, it's a substantial minority. But are you able to size it for us?

Jonathan Howell: In terms of our customer base and in terms of revenue, it's an immaterial number.

Charles Brennan: Okay. Thanks. That's helpful.

Operator: Thank you. Dear participants, thank you for all your questions today. I would now like to hand the conference over to Mr Howell for closing remarks.

Jonathan Howell: Yes, thank you very much indeed for finding the time to dial in. Thanks for your good questions. Your interest is always appreciated. Obviously, if you do have any follow-up questions or require any further information, James and his team will be on standby for today and indeed the rest of the week. So please do call if you have any further questions. And I hope that was helpful. And thank you for your time.

Operator: That does conclude our conference for today. Thank you for participating. You may now all disconnect. Have a nice day.

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