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PRESENTATION

Operator

Good day and welcome to the Sage Group plc Q1 IMS trading conference call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. Steve Hare, CFO. Please go ahead, sir.

Steve Hare - Sage Group plc - CFO

Thank you very much and welcome everyone. Thanks for dialing in to trading update. I'm just going to give an overview, a few highlights and then we'll turn over to questions.

So in terms of key messages, 6.6% headline revenue growth for the first quarter of the year demonstrates continued momentum. The highlight is recurring revenue growth with 10.4%. And whilst this is a promising result, I would exercise some caution as we progress through the year and the comparator develops.

And in particular within recurring revenue, software subscription growth of 35.7% is a good result, benefiting from the success of key initiatives, which we called out at the year end, particularly in the UKI, Sage 50 and Accountants Network, and also in North America, again, Sage 50. But this level of subscription growth is at the upper end of the range that I would expect, particularly as the Q1 comparator was relatively easy.

SSRS decline of 5.3% balances the recurring revenue growth, as expected as we plan to move through the transition to subscription relationships. And therefore in the first quarter we've had less new and upgrade license revenue.

As a reminder, for nearly all the growth products now below X3 the preferred default option is to sell them on subscription.

Processing revenue, the new category which we created at the year end and now includes Sage payroll solutions in the organic measure for the first time, grew by 5.4%. This is still below our ambitions for this revenue stream, which is dominated by payments processing, but we do at least have the right positive trajectory.

In terms of a bit of regional color, Europe had a good quarter with continued momentum, with, again, similar to the year end, France and UKI leading this performance. North America was more or less in line with the full-year 2015 growth, with subscription momentum being the primary driver. In international we had a slower performance here, which was a combination of good growth in Africa, with slower growth in some of the other areas within this region.
In terms of guidance and outlook, the business transformation is ongoing and we will revisit this topic at the interims, where we will give some color on the program and also the exceptional costs incurred to achieve it. As we always say, whilst we expect the transition to be nonlinear, the first quarter does represent good progress. And as we start the year we remain confident in delivering our full-year guidance of 6% organic revenue growth and a 27% operating margin. As I called out at the full-year results, there will be an investment bias towards the first half of the year as we continue to implement our plan for long-term improved quality growth.

So with that, I’d like to open, hand back to the operator and open it for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Milan Radia, Jefferies.

Milan Radia - Jefferies - Analyst

Morning, Steve. Thanks very much. Two questions. The first was in terms of the reinvestment in the digital marketing hubs or customer service centers, I think you’re calling them, how much has been spent? Where have you got to? Have you got -- I think you were planning to have two open. Where does that go from here and what kind of reinvestment are you anticipating over the next year or so?

And number two was just around the payments business and whether you’re seeing a pick-up in the North American business there and whether you’ve developed any thoughts around what the payments portfolio should look like in a couple of years’ time. Thank you.

Steve Hare - Sage Group plc - CFO

Thanks, Milan. So if we take the customer business centers first, we have two operational customer business centers, one in Atlanta and one in Dublin. They’re at the moment focused on launching Sage Live, which is now successfully being launched. And we’re bedding that down and then in due course we’ll be looking to introduce other products through the customer business centers, probably starting with Sage One, but we want to get those two bedded down first. The obvious next step, although we haven’t made a decision yet, will be to look at where we open one in the international region.

And then we -- so in terms of increased investment, digital marketing investment some of it is going through those customer business centers in support of Sage Live. But we are also channeling investment through the regions in order to continue to drive growth, both in the local growth products like Sage 50, which is really leading the way in terms of the switch to subscription, and also at the upper end in support of generating pipeline demand for X3.

In terms of how much we’re spending on the CBCs, there’s two different parts really. One is what it costs you to set them up, which is relatively modest. It’s just the headcount cost and the premises cost, which in the case of the premises is co-located with other things that we’re doing in those two locations. And then it’s a question on the digital marketing. As I called out at the year end, as we create more capacity through the cost savings, we will reallocate that into digital marketing and we’ll talk about that more at the interims. I’m not going to go into details here.

On the payments, we’re starting. In North America in particular the payments business has shown some growth actually, whereas previously we’ve called out that was slightly declining. So that’s why I use the phrase -- at least we’ve got the appropriate trajectory. We’ve made no secret of the fact that we aspire for our payments businesses to show ultimately double-digit growth and in the interim period at least high single-digit growth. So we’re not quite where we want to be, but at least we’re heading in the right direction.
And in terms of the portfolio question, I would say that we've talked about the golden triangle of accounting, payroll, HCM and payments. And at the moment we feel that we have broadly the right product offerings or solution offerings within that golden triangle. And the focus really is putting more resources behind the go-to-market, behind digital marketing to really push the demand generation, as opposed to really feeling that we have any significant product gaps.

**Milan Radia - Jefferies - Analyst**

Understood. Very helpful. Thank you.

**Steve Hare - Sage Group plc - CFO**

Thanks, Milan.

**Operator**

Michael Briest, UBS.

**Michael Briest - UBS - Analyst**

Good morning, Steve. I seem to recall in H1 last year there was a benefit in Malaysia from, I can't remember, a regulatory driver which helped the license sales. Would that be selling in Q1 or Q2, just to look at the software performance?

And then could you maybe talk a little bit about Sage One? And I recall at the full year that the US traction was still somewhat disappointing. Whether there's been any improvement there.

And then just finally, on the balance sheet, in terms of the gearing targets and the willingness to consider buybacks or special dividends at this point or sometime this year. Thanks.

**Steve Hare - Sage Group plc - CFO**

Thanks, Michael. So on Malaysia, it does affect the first half. There’s a bigger impact in Q2 than there was in Q1. As a reminder, the boost was in SSRS, so in the second quarter particularly the SSRS comparator gets more difficult for the international region.

In terms of Sage One, we haven’t disclosed the exact numbers, because it’s a trading update, but I can say that we have similar momentum to that which we had at the year end. And in terms of the regional variation and in particular North America, we’re starting to get some better traction, but it’s still very, very early days and the numbers are small. But I think the key thing in North America is we’re putting more focus on to multiple channels. So and that really means in particular the accountants channel and not just focusing on the digital channel, although the digital channel obviously remains important.

In terms of the gearing target, no real change. We continue to monitor the options in terms of what we do with our free cash flow. Absent any acquisitions then we remain flexible in terms of how we return money to shareholders. We may do share buybacks. I think in this financial year, given where we are on the gearing, we wouldn’t rule out special dividends, but neither would we -- neither would I think it was particularly likely. I think it’s more likely that we may do a small bolt-on acquisition if the appropriate thing comes along. If not, you may see us doing some buybacks.

And also we’re not a complete slave to the guidance. If I felt there was a need to hold on to the cash for other reasons beyond the year end, then that’s also an option. So we’ll just see how the year develops in terms of the opportunities in front of us.
Okay. Thanks.

Thanks, Michael.

Adam Wood, Morgan Stanley.

Hi. Good morning, Steve. Thanks for taking my question. Two also from me. Just on the new business side of things, we've obviously got a mix between the licenses and upgrades down 5%, and the subscription business being very strong, up 36%. I wondered do you track at all trying to make that apples for apples and calculate what the new business is growing overall for Sage if you convert subs to licenses or vice versa? Just to give us a feel for if we try and think about those two together, is it up or down and order of magnitude.

And the second, within the recurring business, obviously the subscription is a big help there. Could you give us any feel for what pricing's been doing on the support base over the last year as well? Thank you.

Yes. So on the new business, I think the way to think about it is the new customer acquisition momentum, so brand new customers to Sage, I would say it remains early days. We're obviously acquiring new customers using Sage One and we're also acquiring new customers using X3. But in the SMB space, whilst we do sign up new customers again using Sage Live and also to some degree products like Sage 50, the numbers are relatively small.

Where the momentum comes from is both switching people within the installed base from the traditional license and maintenance and support contracts to subscription, but also secondly, we are increasingly targeting reactivations, so people who are using the product, but for whatever reason are not -- do not have a maintenance and support contract. And so we're trying to use that as the momentum to tempt people with upgrades and enhanced functionality and bringing them back into the fold.

But the way to think about the growth is today most of the growth is coming from what we call internally customer for life or the installed base. And the contribution from brand new customer acquisition remains modest. And I think as we go through FY2016, you probably continue to see that. I mean we obviously hope that the new customer acquisition will start to pick up, but it is really the installed base that will continue to drive it.

And then as a kind of leading indicator, if you like, as we go through the next few years, if we are to sustain or indeed accelerate our growth rates, the new customer acquisition will need to start kicking in both through, particularly through the global products, but also to some degree through the local growth products.

And then your second question on pricing. In terms of the overall growth rate, as I said at the year end, historically we've probably seen about half the growth coming from price. And I indicated that I thought going forward this was going to start to decline and we'd probably see more like a third of the growth coming from price. And in particular in the low inflation economies like the UK, like the US, the price increases that we're putting through on our maintenance contracts are relatively modest.
So I would say in terms of Q1, the pricing contribution would be more like the third than the half, so it is going down in the direction that we're talking about. And therefore where we're getting our growth from is by bringing, as I say, people back into the fold in terms reactivation and also bundling solutions together to give people a more comprehensive offering through subscription.

Adam Wood - Morgan Stanley - Analyst
Thanks. Very helpful. Thank you.

Steve Hare - Sage Group plc - CFO
Thanks, Adam.

Operator
David Toms, Numis.

David Toms - Numis - Analyst
Hi, Steve, and thanks for taking the question. Just a quick one from me. When you were thinking about planning for this year with regards to cost base, did you set your cost plans based on 6% revenue expectation and therefore does revenue drive some margin of performance or were you automatically assuming that you would beat the 6% revenue number when you chose how much to invest?

Steve Hare - Sage Group plc - CFO
So the key really is the ratio between fixed and variable costs. So what we've tried to do is plan the cost base, the fixed side of the cost base, on the basis that the growth would be around 6%. Obviously we have some, a little bit of contingency, but the idea would be we do it around 6%.

And then what we do is, as we see how the trajectory is developing, it is the variable expenditure, i.e. things like digital marketing, that I flex up and down. So what we do is rather than having a -- if you go back a couple of years, the way Sage would have planned would be to have had a fixed budget for the year both in terms of revenue and cost, and then the regions or the countries would have broadly had the -- would be empowered to spend within their budget. What we now do is we do that on a quarterly basis. So we update all the time on a more agile basis what is available for people to spend and that's based on what we see as the trajectory.

So I'm trying to -- I'm managing on a more live, agile basis how we allocate the resources and therefore what we can afford to spend, depending on what I'm seeing in terms of the trajectory. Now obviously as the recurring revenue gets higher, we get better and better visibility where I think the revenue is going to come out. The one that requires the most judgment is obviously where will license growth come out and therefore where will SSRS come out. But on recurring revenue I've got a pretty reasonable visibility of where I think that's heading.

David Toms - Numis - Analyst
Okay. Thank you very much.

Steve Hare - Sage Group plc - CFO
Thanks, David.
Operator
Charles Brennan, Credit Suisse.

Charles Brennan - Credit Suisse - Analyst

Morning. Thanks very much for taking my question. I’ve got two actually. The first is just on the comps for the second quarter. You talked about the software subscription comps starting to get tougher through the year. You’ve also re-flagged up the Malaysian licenses in the second quarter. Are you budgeting for the second quarter organic growth to be slower than the 6.6% that we’ve seen in Q1 or are there other initiatives going on and that’s not the case?

And the second question is just around the SSRS performance, down 5%. Obviously that relates to some switch to subscription. But on an underlying basis, can you tell us whether there’s any disappointment in that? Has X3 continued to track in line with expectations or have you seen deals slipping through? Thanks.

Steve Hare - Sage Group plc - CFO

Yes. Thanks, Charlie. So on the comps and specifically on where we think Q2 will come out, I think given that we’re sticking with our guidance of at least 6% growth, I think Q2 is, as I sit here today, I would say is probably likely to be below 6.6% because I’m saying for the first half I’m not expecting any acceleration. So 6.6% is probably again towards the upper end of where I would expect to be.

And the reason I say that is twofold. The one that Charlie just pointed out, which is the comparators start to get tougher. But also it links into the second question around SSRS that in the past I flagged that SSRS is likely to start to decline, as we switch to subscription and have less upgrade and you license in SSRS. And in previous quarters and during FY2015 we’ve always had something, some kind of one off, which has meant that I’ve come and said, well, even though I flagged SSRS would go down, actually it’s flat. Well, this time it has gone and I think in Q2 it will also go down, particularly with the Malaysian comparator in Q2.

In terms of whether within SSRS there’s any disappointment, I think overall X3 grew in the quarter around double digit, so it was fine. I think there’s potential for it to grow faster so that’s why I use the word fine rather than great. I still think, as we look across the regions, X3 is not performing consistently or we don’t have the level of pipeline that we aspire to on a consistent basis.

So I wouldn’t call it out as a disappointment as such, but given the length of the sales cycle for X3 and also probably, whilst typically we don’t call out macro GDP influences, there’s a lot of nervousness in the markets. There’s a lot of general cautious commentary. And the one area of our business which hasn’t been impacted so far but could be is if general business confidence is low, people tend to take longer to make decisions. And the place that that impacts is at the upper end with things like X3 deals.

Typically at the lower end people still need their accounting software, they still need to pay people, and it’s much -- a greater number of customers, whereas X3 you’re talking about trying to land 20, 30, 40, 50 new customers. And if you get a general negativity in terms of confidence, that could affect timing. Deals probably won’t go away, but people may take longer to make their minds up.

So I just have a little bit of caution around that. But, overall, as I said right at the beginning, we’re confident that we’ll be in line with our guidance. And in some quarters we may get a little bump up or a little bump down, but the trajectory is where it needs to be.
Charles Brennan - Credit Suisse - Analyst

Can I just ask one quick follow-up? Just on the geographies, you mentioned that some geographies were a bit slower. Can you just talk about Australia? It’s the one market that feels like it could be the most competitive with MYOB, Intuit, Xero and yourselves? Can you just call out the Australian trends for us? Thank you.

Steve Hare - Sage Group plc - CFO

Yes. I think in Australia we've launched Sage One, so from a revenue perspective it's not particularly material. But we have started to get some traction around that. On the wider front in Australia we have a pretty narrow product portfolio, so we -- and we're not really acquiring very many new customers except through Sage One. So it's a pretty steady installed base performance, so we're not -- it hasn't really impacted our results.

When I call out areas that are a bit slower, it's really Brazil, where we've got two parts to that business. We've got a content business and we've got the subscriptions -- sorry, the software side of the business. The software side of the business did okay. It's growing double digit. But the content business is growing more slowly and is more impacted by the recession in Brazil. So it just gives us some caution there. And then across the wider Asian stage, outside of Africa and looking at Asia, again we've seen a bit of slowness.

Charles Brennan - Credit Suisse - Analyst

Great. Thanks.

Steve Hare - Sage Group plc - CFO

Thanks, Charlie.

Vijay Anand - Mirabaud Securities - Analyst

And slightly linked with that, on the SSRS side, so you talked about subscription growth being at the higher end of where you might expect. Can you similarly say whether SSRS' decline could be higher than the 5% that you reported in Q1? Notwithstanding the tough comps, but generally speaking the trend of pushing recurring over non-recurring, would you expect the non-recurring to decline at a faster pace either later in the year or perhaps in 2017?

Steve Hare - Sage Group plc - CFO

Yes. So if we take the first thing on subscription pricing, I think it’s fair to say that one trend is, as you go up the stack to bigger businesses, you get some pushback as you move up the stack. So starting with X3, we do sell X3 on subscription, but more often we sell it on license and there is more resistance at that level to subscription.
As you then come down to products like Sage 100 and 300, again it's a bit of a mixture. We do still sell -- so, for example, in North America Sage 100, Sage 300 upgrades, we do sometimes sell those on licenses. Where we sell cloud versions we tend to hold the line more in terms of them being available on subscription. But we don't want to lose customers. So sales teams still have the flexibility to come back and get approval for selling on license where appropriate.

As you go down, Sage 50, no, not really. It's really getting a lot of traction. Customers like it. It's easier. We're bundling things together. They like the predictability.

And then in terms of geography, it's getting a lot of momentum in Europe. From a low base, it's getting more momentum in the US, but it has been slower to take off. And then in international it's mixed. We have established recurring revenue in a number of the markets, but in parts of Africa there's more pushback. But I would say in general the trajectory is very much towards greater and greater acceptance across the board.

And obviously, as we look against particularly our cloud competitors, the cloud competitors are all selling pretty much exclusively on subscription so that's also helping to support the developments in the market.

And then in terms of SSRS, I've said quarter by quarter this can vary quite a bit depending on what's happening in each of the regions. So could SSRS decline be greater than 5% in particular quarter? Yes, it could be. And I think particularly Q2 with the Malaysian comparator we could see a higher decline, which is why I'm being a little bit cautious in terms of, for example, the overall 6.6% and not wanting for people to see that as a new threshold. It will vary quarter by quarter as we go through this change. But I think we're showing in the numbers that we're managing that mix very successfully.

Vijay Anand - Mirabaud Securities - Analyst

Got it. And a quick follow-up on PayChoice. Could you say, given that this is the first quarter it's contributed to the organic growth, could you say whether it was a positive contributor or whether the growth was similar or less than the 5% reported by processing revenue overall?

Steve Hare - Sage Group plc - CFO

Yes. It was a positive contributor.

Vijay Anand - Mirabaud Securities - Analyst

Okay. Great. Thank you.

Steve Hare - Sage Group plc - CFO

Thanks, Vijay. So I think if there's no more questions, we'll bring the call to a close. So thanks very much everyone again for dialing in and thank you everyone for your questions and we look forward to seeing you again when we come out with our interim results. Thank you very much.

Operator

Thank you. That will conclude today's conference call. Thank you for your participation, ladies and gentlemen. You may now disconnect.