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Q1 2020 Sage Group PLC Trading Statement Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to The Sage Group Q1 Trading Update Call. (Operator Instructions) I would like to advise you that your conference is being recorded today on Wednesday, the 22nd of January 2020.

I would now like to hand the conference over to your speaker today, Jonathan Howell, Chief Financial Officer. Please go ahead, sir.

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

Thank you very much, and welcome, everyone, to Sage's Q1 trading update call. First, I'll give you a quick update on the key numbers, and then we can open for Q&A.

Just as a reminder, all numbers in the trading statement are on an organic basis, stripping out the impact of assets held for sale, which include Sage Pay and our business in Brazil. So as you can see in the release, we've made a strong start to the year, maintaining our focus on subscription and the cloud as we transition towards becoming a great SaaS company. Recurring revenue increased by 10.7% in Q1 to GBP 410 million. This was underpinned by software subscription growth of around 25% to GBP 286 million. And this means we now have 61% subscription penetration, up from 55% at the year-end.

This strong recurring revenue growth has been driven principally by our largest regions of North America and Northern Europe. North America grew by almost 12% to GBP 154 million due to continued success in growing cloud-connected solutions, together with a strong performance from Sage Intacct. In Northern Europe, recurring revenue grew by 15% to GBP 93 million. This benefited from strong momentum in the second half of FY '19, together with new cloud-connected contracts added in the quarter. The portfolio view of recurring revenue also demonstrates our focus on delivering growth in line with the strategy. The Future Sage Business Cloud opportunity grew recurring revenue by almost 13% to GBP 362 million.

Turning to other revenue, which is SSRS and processing combined. This revenue category declined by 15.8% to GBP 55 million, in line with the continued transition towards subscription revenue and the move away from low-margin professional services. And the impact of all this is total revenue growth of 6.7% to GBP 465 million.

In summary, Sage has got off to a good start in FY '20, which as we all know is crucial in a subscription-led business. At the FY '19 results, we called out that we exited the year with strong ARR growth but that we expect this growth to normalize. Revenue growth in Q1 was, therefore, in line with our expectations, and we reiterate our previous guidance for the full year. And as a reminder, this is recurring revenue growth of around 8% to 9%, high single-digit decline in other revenue and organic operating margin of around 23%.

Thank you very much. And now let's open for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from Amit Harchandani from Citigroup.

Amit B. Harchandani ***Citigroup Inc, Research Division - VP and Analyst***

With regards to questions, a couple, if I may. Firstly, Jonathan, could you kindly provide us with a bit more color in terms of the dynamics between new customer acquisition and migrations? You've called out cloud connected, so it would be good to know how the 2 drivers are playing out and how you expect the trend to be over the rest of the year. And then I have a follow-up question.

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

Yes. Okay. In terms of looking at the performance so far in Q1. Look, first of all, in terms of FY '19, we exceeded our expectations in growth in terms of recurring revenue and ARR as we had very strong sort of tailwinds during the course of last year with the Sage 50 migrations in Northern Europe and North America that move rapidly and also making tax digital. So that means as we entered FY '20, we had a good ARR sort of entry rate, which has given us some momentum. But nonetheless, during the course of the year, we've seen continued reactivations, NCA and also continuing migrations as we move into FY '20. But these are at a more moderate level than we saw during FY '19. I think the important thing to say -- also say is that at this stage, at the Q1 stage, the business has performed exactly in line with our expectations and the phase plan that we had for the year.

Looking forward further into the year, we've got further migration opportunities for Sage 200 in Northern Europe and North America. In Northern Europe, we also have further migrations coming through in Sage 50 Payroll as that moves to cloud connected. And in Canada and France, we've still got lots of runway on migrations, which will also include reactivations, we believe, in Sage 50 and Sage 200. So all in all, there's a sort of a mix of growth here, which is also supplemented by the strong subscription growth that we're still seeing from Sage Intacct, which at a Q1 stage came in at recurring revenue growth of about 31%. So all in all, we're sort of very content with where we are. And you can see that albeit at this early stage in the year at Q1, we've reiterated our guidance for recurring revenue.

Amit B. Harchandani ***Citigroup Inc, Research Division - VP and Analyst***

And secondly, if I may. You talked about focusing on parts which are held for disposal. And last time around, you called out Sage Pay. You obviously also talked about Brazil. So could you give us an update on where we stand with regards to those corporate actions? And how can investors think about the subsequent capital return?

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

Yes, yes. Thank you. Yes, so Sage Pay. As you know, that was held for sale at the year-end. And indeed, we'd announced a transaction. We said then that we expected it would complete in Q2 FY '20, and that's to the best of our knowledge is very much on track at this stage. So again, we believe it will close in Q2. The transaction in relation to Brazil, we're well into a process, and again as and when we have further news, we'll update you on that. And yes, at the year-end, we announced a capital return of GBP 250 million. That capital return will commence on completion of the Sage Pay deal once we've received the cash, and we will update you at that stage at what the mechanism for the return will be.

Operator

Your next question comes from the line of Adam Wood from Morgan Stanley.

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

I've got 2 as well, if I could, please. Just first of all, on the recurring growth. That's remained pretty strong versus the end of last year. But on the other hand, the subscription growth within that slowed a little bit versus where we were in the second half. Could you just maybe just talk a little bit about what the moving parts are within that recurring business? And what's offsetting that slight slowdown in the subscription growth and the rest of recurring to enable you to keep that at such a strong level on recurring overall? And then maybe secondly, as a follow-up on the remaining migrations that you have and reactivations to come on Sage 50 Payroll and Sage 200. I think you talked about a decent price uplift when you did the existing Sage 50 migrations, especially in the U.K., would you be expecting to see similar types of price uplifts on these migrations that are still to come?

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

Yes. So in terms of the continuing migrations, Sage 50 Payroll. Yes, we will be having ongoing uplifts in price as we migrate to subscription. Sage 50 in Canada and Sage 50 in France, we will have ongoing price lifts. In terms of Sage 200, though, those prices will be more moderate, particularly in France. So there's a mix of outcomes in the ongoing migration strategy.

And in terms of the recurring revenue question that you had. The Q3 and Q4 in terms of ARR and recurring revenue build were very strong, particularly in Q4, and indeed, in month 12. But in Q1, we continue to add and continue to grow ARR as we entered FY '20. And if you look at the last 8 consecutive quarters, you can see that sequentially, we continue to grow recurring revenue throughout the last 8 quarters. So we're beginning to get the consistency that we need as we move towards becoming a SaaS company.

And I think just in terms of the phasing, as I say, we're very much in line with our expectations. The business is performing as we planned at this stage. And as we move into the second half, which is exactly what we were pointing out during FY '19, we do move against these tougher comparators. So we do expect the growth rate to slightly moderate. I think there's a broader point as well around the transition that we're going through. And I know we sort of talked about it several times during the course of last year. We are doing this transition. It will be a multiyear process. We're doing it across a number of territories. We're doing it across a good number of products. And therefore, this transition is not going to be linear. And that's exactly -- this is exactly what we're seeing. We're getting different waves of growth. So FY '19, we set out with expectations of 8% to 9% recurring revenue growth. And we outstripped those expectations for the reasons that we discussed. And now we're just coming back to a slightly more normalized level of growth as we can see it at this stage of Q1. But clearly, we'll get you up -- we'll keep you updated during the course of the year.

Operator

Your next question comes from the line of Paul Kratz from Jefferies.

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

Jonathan, just one question from my end. When I look at your recurring revenue run rate, going out of the fourth quarter and your recurring revenues that you achieved in the first quarter, there seems to be a bit of a discrepancy. Basically, the GBP 1,685 million that you printed implies that you should be hitting somewhere in the area of about GBP 415 million, GBP 420 million in recurring revenues during the first quarter. I mean, could you explain maybe what are the moving parts that led you guys to kind of hit more towards GBP 410 million? Is it basically FX that's offsetting some of the new customer adds? Or are there other parts that we should be kind of aware of in that whole dynamic?

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

Yes. So first of all, in terms of FX, I mean, good point on that. So obviously, what you're looking at is a restated organic as a comparative. And we have got FX headwinds as we sort of pointed out in the release. But all in all, that won't change the growth rate. It will reduce the comparative back to current FX rates, so we're comparing like with like. The growth rate remains unchanged. In terms -- I mean, fundamentally, what we're doing is we're comparing ARR versus recurring revenue. And that was ARR for the last month of last year, where we had a very, very strong Q4 and a very strong month 12 as we sort of accelerated through the Sage 50 migrations in Northern Europe and North America. Both of those are now over 90% penetrated. So that really drove ARR very firmly. And similarly, that was just at the tail end of making tax digital impact. So that month 12, which drove that ARR, was strong. And as we move into Q1, very much more moderated growth as those tailwinds, which we called out consistently during the course of the year, sort of drop away in terms of new additions during Q1. What I can say is, and I've said it once already, is that what we've seen for Q1 is absolutely in line with our expectations. And so the business is performing in a consistent way according to our phase plan. And as I say, this is what we would expect as we move towards a more consistent recurring revenue and subscription revenue stream as we move to a SaaS business.

The other thing that's just sort of worth pointing out is that the subscription revenue growth of 29% last year versus 25% this year in Q1 so far, that mirrors exactly what I've just described. But also in terms of subscription, we're doing that off a much larger base. It grew by almost 30% last year. When we exited last year, we had GBP 1 billion of subscription revenue. And as you can see, at Q1, we're almost at GBP 290 million. So as we get a larger base of subscription revenue, that will moderate as well.

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

So I mean, just maybe a follow-on question then. If we go into the first half, do you expect ARR to be significantly above GBP 1.7 billion at this point?

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

We're not -- over and above what we said in our guidance, we're not going to be giving you any more guidance. But you can see that we've got momentum in ARR. I've said to you that we've continued to build ARR in Q1 on Q4. And at the Q1 stage, we're content with our total -- our recurring revenue guidance for the full year.

Operator

Your next question comes from Mohammed Moawalla from Goldman Sachs.

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

Great. Jonathan, could you comment on sort of renewal rates? I mean, I'm just -- when I look at the recurring performance, given the software subscriptions were essentially reasonably steady or modestly down, the -- in terms of growth. But have you seen any sort of change in renewal rates on kind of maintenance? And second question on Northern Europe, that was you called out is quite strong. I mean, in the U.K., how long do you see the tailwinds from sort of tax, digital tax, continuing? Or do you think these will kind of fade as we move through the year?

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

So in terms of renewal rates, obviously, we're not disclosing that now at the Q1 stage, but just in broad terms, I could say it's very consistent for the full year renewal rate that we reported last year at the year-end. It's pretty consistent with that. No material change with regard to that. And then in terms of what further runway have we got in the U.K. It's -- as I've sort of described almost earlier in terms of we've got a range of products that are continuing to migrate to the U.K., Sage 200 and Sage 50 Payroll. As well as don't forget that we are now just beginning to begin to sign off first customers in Sage Intacct in Northern Europe in the U.K.

Operator

Your next question comes from the line of Stefan Slowinski from Exane BNP.

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

Actually, just following up on the final comment there around Sage Intacct and the launches in the U.K. and Australia. I was wondering if you could give us any insights as to how those are going. Are those proceeding as planned? Are you happy with the channel that's been put into place? How you're seeing kind of first customers signing up? And presumably, there wasn't much impact, if any, in the quarter, are you actually building in any contribution from Intacct U.K. and Australia in the full year growth numbers? Or should we wait until next fiscal year to see tangible evidence?

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

Yes. So thank you, good question. So look, we're signing customers. We've made a good start. It's going according to plan. But I think to your point, it's not going to make a material revenue impact or ARR impact for Northern Europe, given the very significant installed base that we've already got. But we continue to sort of update you on progress at the half year and the full year.

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***

Jonathan, a couple from me. Just in terms of recurring revenue growth, if I look at Continental Europe/International, it's around 7.5% calculate. What can you do to drive an acceleration there as the sort of pace of subscription and Sage business in North America and the U.K. is so much higher?

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

Yes. Michael, look -- thanks. So you're absolutely right. As a -- as you say, you can drive a 7.5% growth rate for the rest of the group in recurring revenue, it's clearly making a contribution, but not running at the same levels as North America and Northern Europe. And in terms of the migration strategy. France, we're only about halfway migrated through Sage 50 and Sage 200. So there's plenty of runway there. And in Iberia, there's further -- there's a lot of runway to go as well for Sage 50 and Sage 200. So as we've said, there are waves of growth. The various territories and the various partner channels will be ready for migration to business cloud and subscription at different rates.

Operator

Excuse me, ladies and gentlemen, we seem to have lost our speaker. (technical difficulty)

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

Apparently, we were dropped off the line by the conference center.

So Michael, I don't know to what extent you heard my answer in relation to the...

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

Yes. I think you were talking about sort of ways of growth. I'm not sure if you said much more after that on sort of Europe, international. And then I had a follow-up, but...

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

Right. Yes. So just a completeness, to what extent I don't know how much you heard, we have further growth to come, particularly in France, and particularly in Spain, where the migration strategy is only in part achieved -- we're only about halfway through -- halfway through or less in those territories on Sage 50 and Sage 200. And that's partly because those territories at this stage are less cloud adoptive but also because we're now also getting the channel working with us, particularly in France to affect those migrations. So more to come from those territories in due course, but we wouldn't anticipate that migration to be as rapid as Sage 50 in North America and Northern Europe because much of that is direct and in the small segment.

And your second question -- Michael?

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

Yes, I was just -- I mean, obviously, now at quarter end, do you have any more feel for the margin seasonality between H1 and H2 and on the timing of the launch of the multi-tenant cloud version of Sage 50?

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

Yes. So in terms of margin, I'm very content with where we are with margin at the Q1 stage. Again, it's very much as we expected. It's too early to be talking about H1 and H2 phasing. But clearly, we'll sort of give you an update at H1, but it's exactly where we hope it to be and gives us the confidence to sort of reiterate guidance of around 23%.

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

And on the product launch (inaudible) cloud in the summer?

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

Yes, yes. So...

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

I mean, is that out for the pre-June or pre-September?

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

To be determined. The plans are progressing. It's in line. That's an important launch for us because that's obviously the Stage 50 accounting segment professional users, which really is the read across from Sage 50 cloud connected. So it's very much in line, and that will be launched in Northern Europe during the course of this year.

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

The calendar year or the fiscal year?

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

Oh, sorry, financial year. Thank you. Thanks for the clarification.

Operator

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

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

Great. Just 2 quick questions, actually. Firstly, in terms of the growth rate. Your recurring performance is obviously slightly flattered by the removal of the Sage Pay and the Brazilian business. Can you just help us quantify what's removing those low-growth assets have done to the growth rate during the period? And then secondly, I'm still trying to get my arms around what the real level of underlying growth should be on a go-forward basis. You've talked about this multiyear, multi-product, multi-territory migration program that you're going through that's obviously boosting growth at the moment. If you actually look at the products and the geographies where you think the migrations are largely complete, can you give us any insights into where you think recurring revenue growth is settling?

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

Yes. So first of all, on the stripping out of Sage Pay and Brazil. They have a very limited content of recurring revenue. Sage Pay in its entirety was [payroll] processing revenue, so therefore, has no impact on the recurring revenue growth rate. And indeed, Brazil, again, had a reduced element of recurring revenue, and much of the revenue from Brazil was also in the other line, which has had no current path to migration. So if you look at all of those, if you look at the impact, it doesn't really have a material impact on the growth rates overall.

And in terms of the growth rate, what is a normalized rate? Well, I think at this stage, I think the best guidance that I can give you to that is that if you look at last year, we set out, beginning of the year, with our best estimate of how the business will perform, and that was a recurring revenue growth rate of 8% to 9%. And for all the reasons that we explained during the course of the year, we outperformed. And then when we restarted planning for this year and thereafter, we looked across all of the things that we've got to do in terms of NCA reactivations and migrations, and we're still getting that in Northern Europe and North America, albeit at a reduced level. Looking at the cross-sell and the up-sell that we can achieve, particularly with the new products, like AutoEntry that's made a good start in the U.K. and also the native cloud NCA, which is still driving forward in a very consistent form. We look at all of that, along with some of the other territories where we've got revenue that may not have a pathway for the cloud, albeit recurring revenue, and we've come out at 8% to 9% again. And I think as an important dynamic, an important dynamic of that is we get more consistency in execution and more capability to run this like a SaaS business, then we have confidence that we can build off that type of recurring revenue growth rate.

The other thing that will impact total revenue is, obviously, as you can see, the SSRS and processing other is declining. That decline in Q1 was exactly in line with our phase planning for the year. But that does mean now that, that's rapidly moving down to only about 10% of revenue, and we'll be getting the full benefit of the recurring revenue growth rate without it being dilutive about the -- by the move away from SSRS.

So all in all, I think that's the best guidance I can give you at this stage. And as you know, we're not doing multiyear guidance. We look at it on a year-by-year basis, but we'll keep you updated.

Operator

And your next question comes from the line of Toby Ogg from JPMorgan.

Toby Ogg ***JP Morgan Chase & Co, Research Division - Analyst***

Just wanted to kind of follow up again on the SSRS side of the business. Clearly, the declines are actually much larger than sort of what the guidance was looking for, for the full year. And looking back to Q1 '19, the comp wasn't particularly tough there either. So I'm just wondering why the decline was so large in Q1 this time around. And I guess -- would you expect those declines to moderate through the year?

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

Yes. Thank you for the question. So look, I mean, first of all, as I say, it's performing exactly as we expected when we planned the year. It's driven by 2 factors. One is, we're moving away from licenses to subscription. So all of our efforts is writing business on a subscription basis and not on a license basis. So that's part of the transition. And the other part of the transition is, we are doing less and plan to do less low-margin professional services revenue, which we don't believe has a significant role to play in a true SaaS business. So those are the drivers. In terms of just looking at Q1 last year, FY '19, that was actually a tougher comparator. So if I look at Q1 last year, SSRS declined by about 5%. And by the time we get to the full year, the decline for the full year was 20%. And the Q4 last year was an excess of 20% decline. So that sort of underpins our sort of current expectations that leaves us to hold sort of the guidance to high single digits.

I think the important thing to say about this is that this is completely compatible with the strategy, and this is exactly what we should be seeing at this stage is pushing ahead strongly on subscription and recurring revenue, whilst the legacy business -- where and whilst the legacy business transitions to the new model.

Toby Ogg ***JP Morgan Chase & Co, Research Division - Analyst***

Brilliant. That's very helpful. Just one follow-up actually on the competitive environment in the U.K. specifically. I know Xero are sort of accelerating their kind of penetration into that market and into -- in the U.S., they've been talking about QuickBooks Advanced and the potential for there. Just wondering if you've seen any change really in that competitive environment. And just would be more interested to hear what you've been seeing there.

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

Yes. So no, we haven't seen any change at all. So just to explain. We're not focused on the micro segment. We're focused on the small segment for professional users. And we see no change in the competitive environment. And importantly, as discussed earlier on the call, we've got Sage accounting for professional users, which will be launched in Northern Europe during the course of this financial year.

Operator

This is all we have time for. I will now hand back to Jonathan Howell. Please go ahead.

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

Yes. So thank you very much, indeed, for your questions and your interest. Clearly, if you have any further queries, we'll be available during the course of today and thereafter to take any further questions that you have. Thank you very much.

Operator

Ladies and gentlemen, this does conclude our conference for today. Thank you for participating. You may all disconnect. Speakers, please stand by.