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Q1 2021 Sage Group PLC Trading Statement Call

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PRESENTATION

Operator

Ladies and gentlemen, welcome to the Q1 Trading Update Call for The Sage Group. Your presenter today will be Jonathan Howell, Chief Financial Officer; who is joined by James Sandford, Head of Investor Relations.

I would now like to hand the conference over to Jonathan Howell. 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. I do hope you are all safe and well. First, I'll give you an update on the key numbers and also on 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 performed in line with expectations in the first quarter against strong comparators. Recurring revenue was up by 4.7% to GBP 408 million. This was supported by software subscription growth of around 11% to GBP 303 million. As a result, subscription penetration is now at 68%, up from 65% in FY '20.

Regionally, North America delivered growth in recurring revenue of over 6% to GBP 160 million, driven principally by good performance from Sage Intacct. And in Northern Europe, recurring revenue grew by 3% to GBP 96 million. This mainly reflects momentum from cloud-connected products as well as growth in cloud native solutions.

Performance in other regions was largely in line with expectations. Recurring revenue for the Future Sage Business Cloud opportunity grew by over 6% to GBP 366 million. This was underpinned by strong growth in cloud native revenue of almost 27% to GBP 63 million, primarily through new customer acquisition. And recurring revenue in the other portfolio was down by 7% as we manage this portfolio for value. As a result, Sage Business Cloud penetration increased to 64%, up from 61% in FY '20.

As we announced at our full year results in November, we are progressively increasing our investment in product development and sales and marketing during FY '21. We will flex the level of investment during the course of the year in response to trading conditions. This is expected to drive further growth in recurring revenue.

Now turning to other revenue. This decreased by 24% to GBP 39 million, a similar rate of decline to FY '20. This reflects our strategy to transition away from licenses and low-margin professional services. And the impact of all this is total revenue growth of 1.4% to GBP 447 million.

The group's balance sheet remains strong. And as at 30 December, we had cash and available liquidity of GBP 1.2 billion and net debt of GBP 129 million.

Now moving on to the outlook. Whilst the pandemic increases uncertainty in the near term, revenue growth in Q1 was in line with our plan for the year. We, therefore, reiterate our previous guidance for the full year: recurring revenue growth in the region of 3% to 5%

weighted towards the second half; other revenue will continue to decline, in line with our strategy; and organic operating margin of up to 3 percentage points below FY '20, depending on the level of additional investment we make.

In summary, we have continued to make good progress in the first quarter and have delivered against our strategy. Thank you. And now let's open for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) First question came from the line of Stacy Pollard from JPMorgan.

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

Two for me. First of all, how do you feel on new customer acquisition, especially with the new cloud native products? And how is the traction with Sage Intacct in the new markets?

And second question, would you say current trading conditions have put you in a situation of utilizing the full investment in R&D and S&M? Or are you still holding back sort of waiting to see how the year progresses?

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

Thanks very much, Stacy. First of all, on NCA, I think a couple of things just to note. First of all, you can see that the strong growth that we've had in the first quarter has come from the cloud native products, which grew by 27% in terms of recurring revenue, and that includes Intacct in North America and all of the new territories where we rolled out Intacct last year.

But also we must not underestimate the growing cloud native portfolio. We've got Sage People. Sage Accounting in the U.K. has done well; Sage HR, which was previously CakeHR; and also AutoEntry. So if you take all of those together, we've seen good levels of growth, and the majority of that growth has come from new customer acquisition. And if you take Intacct in the new territories outside of North America, in Q1, they added ARR of up to about GBP 1 million during the first quarter, which is very much in line with our expectations.

I think the other thing that's just worth saying is in terms of investment, to answer your second question, the investment that we've made in the first quarter was absolutely in line with our expectations. And as we've said, that's focused on cloud native products and is in product in R&D and also sales and marketing. We see no reason at this stage to change our investment plans for the full year. And so therefore, that is tracking exactly to how we had originally planned.

But as we do say in the announcement, and we will keep repeating, we will keep that under review, and we will only spend sales and marketing dollar where we see the market opportunity. And then secondly, we will only continue to invest depending upon the market conditions. But otherwise, very much running according to plan, with the bulk of the revenue growth that you've seen coming from new customer acquisition.

Operator

We have another question from the line of Adam Wood from Morgan Stanley.

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

One was on the recurring revenue growth. So we're at the top end of the guidance in the first quarter, which had the most difficult base comparison of the year, and those comps ease through the year. Is there any reason you wouldn't be comfortable thinking about the top end of that recurring revenue growth guidance for this year?

And maybe as a kind of follow-up question, would -- could you help us out on churn? Is that one of the reasons why we're still in that 3% to 5% range rather than at the top end?

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

Thank you, Adam. So just in terms of the performance, yes, this is a good performance because it's against a very strong comparator. Q1 last year, we grew at 11%. But what we've seen during the course of this year is both -- this first quarter, both NCA, but also ongoing migrations in Sage 50 Payroll, cloud-connected in the U.K., and Sage 50 and Sage 200 in Central and Southern Europe.

The trajectory of growth that we see is very much as we described it and reported on it in the second half of last year. So if you recall, ARR, which is the underlying lead indicator performance of the group, was running at about 10% growth at H1 last year, and it reduced to 4.8% in growth rate by the year-end. And I can say that in Q1, we are operating at a growth rate a little bit below that.

Nonetheless, we were seeing sequential growth, so sequential growth in ARR and recurring revenue. Q1 on Q4 last year was up by about a percentage point. And that really underscores the plan that we have for the year, which we're delivering against, is for the growth rate in ARR to sort of bottom out in the first half of this year and then accelerate in the second half as the benefits of the investments come through and the benefit of go-to-market in our full cloud native product suite. So I think that underscores our confidence in reiterating the guidance of 3% to 5%.

The second part of the question was around churn. And I think it's probably just me giving us a snapshot on the ARR build in Q1. And I think the key message here is that it is absolutely in line with what we saw in the second half of last year. And so renewal rate by value in the second half of last year was running at about 97%. In Q1, we're more or less in line with that, 96% to 97% in that type of range. And that's really driven by a slightly lower level of upselling, cross-sell than we saw prior to COVID as customers are careful about taking on new products and additional user licenses.

The very encouraging thing is the churn is absolutely unchanged. And so therefore, the rate of churn that we've seen in Q1 is absolutely in line with what we saw compared to H2 last year, which, in turn, was in line with H1 last year, which fell before the first lockdowns as a result of COVID. So throughout all of last year and Q1, our churn rate is completely consistent.

And then just to sort of finish the story in terms of ARR build, so you can understand the growth rates that we're expecting. New customer acquisition, if you recall, as we exited last year, it was running at about 80% of what we had been seeing on a pre-COVID basis, and again, at Q1, that's absolutely in line with that, but probably more skewed now to the cloud native products. And you can see that in the growth rates that have been generated.

Operator

We have another question from the line of Will Wallis from Numis.

William Alexander Edward Wallis ***Numis Securities Limited, Research Division - Head of Research***

I wanted to just ask a question about the growth in the cloud native. And I know you said that most of that has to do with new customer acquisition. But to what extent are you able to mine your existing customer base, your cloud-connected customer base and all the customer base, in terms of winning customers in that cloud native set -- product set?

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

That's a good question. And I think, importantly, in parts of our portfolio, we are now beginning to see migration from on-premise and cloud-connected into the cloud native environment. And I think the ones that I would call out is, first of all, we've got X3 cloud, which is a new product, which is effectively a cloud-based X3. That has done well in parts of Continental Europe in the first quarter. We also have Sage Partner Cloud, which is enabling our partners to take the Sage 200 base in our major territories, principally in North America, and move that into a hosted cloud native environment, which is -- which, again, is showing some good traction.

And then lastly and probably most encouragingly, we are in North America now seeing numbers of our Sage 50 base moving to Intacct. And so although our primary sort of push at this stage is cloud native NCA across our product suite, we are also now beginning to get some traction in that critical migration. And we're probably running again better than original plans in some of those areas.

Operator

We have another question from the line of James Goodman from Barclays.

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

Just to follow up on the detailed ARR comments that you made. I think you said it was up about 1% sequentially organically from Q4, which is a good performance. Just to simplify that one step further in terms of the sort of questioning around the phasing of growth this year, does that mean -- I mean -- I think it means -- I just wanted to check that, I mean they sort of slight further softening in recurring in Q2 and then maybe turning around, but it's more that we're expecting ARR now to be second half-weighted and then necessarily the sort of recurring revenue growth as a headline measure.

The other question I had was just on North America, where we saw, I think, recurring growth around 6% from 11% last year. I just wondered if that was really a change in sort of Intacct growth rate or the core business there, whether you could say something on the sort of expected Intacct performance through this year.

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

Yes. So just taking the first question, James. The -- we've got a plan for this full year, which was set in place at the back end of the summer and early autumn. That -- given the trajectory in ARR that I've just described, very much envisaged a slowing down of ARR in the second half of last year and then bottoming out in Q1, Q2 of this year and then exactly, as you say, accelerating in the second half. And that's really driven by the market conditions that we see and how they could evolve, but also the payback from the investment that we're making in both products and sales and marketing, and also getting traction in our cloud native product set, which is, as you know, apart from Intacct, has only been sort of put together in the last 18 months or so in its current shape and form. And that gives us confidence for the second half.

But in terms of identifying precisely quarter-by-quarter differential growth rates going forward, that is something that we're not willing to do at this stage. There is uncertainty out there in terms of the economic impact of lockdowns and such like, but we are confident of the general trajectory that I've just painted, which, I think, of course, with your understanding as you put it in the question.

And then in terms of North America, it's a good performance. Again, that was off very strong comparators in North America in Q1 last year. If you recall, those Q1 comparators had been driven by the rapid Sage 50 migrations that we've seen in FY '19, which led to an outperformance, effectively, which then led through into Q1 of last year.

And really, the growth there is driven, as you'd imagine, with the cloud native products; Sage Intacct, which is doing well; migrations -- Sage Intacct -- NCA migrations to Sage Intacct. But then the underlying Sage 50, Sage 200 base has proved extremely resilient and indeed has performed better than we anticipated in our original plan for the year. So all in all, we're content with the performance in North America.

Operator

We have another question from the line of Paul Kratz from Jefferies.

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

Just a couple of questions on my end. I think with the performance you've had so far in the first quarter, do you think this gives you a lot more breathing room to maybe take an opportunity to invest maybe more in the business, whereas, historically, you maybe didn't have the luxury to do that?

And I think when we start looking obviously at the period that's being talked about today, this obviously represents probably the most favorable part of -- yes, I guess there's the lockdowns, with the phasing and the lockdowns. Is there any commentary you can kind of give around trading in December when maybe lockdowns did start to pick up, and there was probably greater uncertainty amongst your customer base?

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

Yes. So I mean, just dealing with the lockdown question, if we just take the U.K., which is one of our important territories, but it's pretty consistent with other territories. We've now entered our third lockdown in the U.K. The first was in the spring and early summer, sort of April, May, June time. Second, as you said, it was in December, and now we have a new one in January.

The business has performed very consistently throughout those periods, and that's something that has underpinned the resilience that we felt that we had in our customer base. And we've seen no change in performance in Q1 from what we were seeing in Q4 last year. So I think that's very important.

Sorry, and your first question, please remind me again. I beg your pardon.

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

Yes. With the recurring revenue growth that you guys have delivered in the first quarter, it gives you a lot more breathing room in the context of your guidance to invest much more in the business, which, historically, you might not have been able to do. Will you take that opportunity basically in the first half to invest as much as possible in the business?

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

Yes. Good question. Look, at this stage, we're investing hard against the plan that we set out, which led to the guidance that we gave at the end of last year, in the FY '20 results in November. And we have not had to change, defer or modify those plans in any way whatsoever. If the growth rate accelerates beyond our plan, well then, naturally, yes, we will, to your question, invest further.

And then just to sort of reiterate for everybody, the guidance around margin is that we will continue to invest. We anticipated at the time of the results announcement in FY '20, but that could lead to a reduction in the underlying operating margin by up to 3 percentage points. We're reiterating that guidance again. But importantly, we also said that, that margin will begin to increase in the years thereafter. And that's a very important part of this business model. As we get traction in cloud native NCA with good growth rates, we're able to invest more. But also, we see absolutely no reason why there's not an opportunity for expanding those margins back -- over time back to where they previously were. But at this stage, as you know, this is the investment stage.

Operator

We have another question from the line of Charlie Brennan from Crédit Suisse.

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

Congratulations. It looks like a nice start to the year for you. Can I just ask 2 questions? Firstly, on the other revenue line, that's obviously come down a long way. Can you just remind us what's left in that and where should that revenue line start to stabilize?

And then secondly, on a separate topic, you stressed the strength of the balance sheet in the statement, and the balance sheet is obviously stronger than it needs to be. Can you just remind us of what your key priority is for that balance sheet? Is it sensible bolt-on M&A? Or is it more likely to come back to shareholders?

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

Both good and important questions. First of all, in terms of other revenue, that, as you quite rightly say, continued to decline, decline to 24% in Q1. That's absolutely in line with what we saw throughout last year. And the runoff of that portfolio of products is going to continue. And that's just naturally part of becoming a SaaS business as we move away from licenses. And we're clearly seeing benefits in the subscription area through that runoff of licenses, but also professional services revenue. It will continue. It's now less than 9% of total revenue, and therefore, we're not going to give sort of guidance quarter-by-quarter. It is a process. It is a multiyear process, and that's fine. Importantly...

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

Is there a level of base services that continues? Or does it trend to 0 over time?

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

No, you're absolutely right. There is a level of base professional services. And in some instances, for large and complex manufacturing, there may still be need for licenses on an on-premise environment. So there is a baseline. At this stage, we're not sort of giving sort of midterm guidance on where that baseline was settled. But you're absolutely right in your assumption.

In terms of balance sheet, very importantly, GBP 1.2 billion of cash and liquidity. That is exactly where we were at the year-end and pretty consistent of where we were at the first half stage last year. We have been very careful and clear to reiterate our capital allocation policy, and that still stands very firm on a pre-COVID basis and now on a -- during a COVID and post-COVID basis.

The first priority is to invest through the P&L organically, and that's exactly what we're doing this year. I referenced the questions around margin. Secondly, we will and continue to do bolt-on acquisitions to supplement our product set. And as you can see, during the first quarter, we invested -- we made an equity investment in Brightpearl, which is a digital e-commerce and retail platform.

And then thirdly, the dividend, very clear commitment on that, very important element of total shareholder return. And you can see that we've done that in the last 2 years, with a 2.5% increase in FY '19, 2% increase last year. That is an absolutely important part of our capital allocation strategy.

And then lastly, we will consider capital returns or share buybacks, as you say, as and when we think it's appropriate. At this stage, looking at the opportunities for this business and the investment that we want to make, we think that the best use of those funds for shareholder value is to continue to invest in the business and do bolt-on acquisitions where appropriate. But to your question, clearly, we will keep capital returns under review, and that is something that we'll do in the normal course of business. But at this stage, we're very much more committed to the investments in the business.

Operator

We have time for one last question, and it came from the line of Ross Jobber from Citi.

Rosslyn Antony Jobber ***Citigroup Inc., Research Division - MD, Deputy Head of EMEA and European Research & Research Analyst***

A sort of fitting last question, in a way, and as much as it's a sort of a bigger picture, longer-term question, if I may. Given where the group is in its transition and given the uncertainty that there currently is in the market, a longer-term investor, corporate investor, might actually see this as an opportunity to invest/buy Sage. Do you -- my question, I suppose it's difficult to answer, but my question is, do you feel that Sage, at the moment, given -- just given where it is in its transition, is vulnerable in that respect? Does the Board expect any approaches, or, to the extent you can comment on it, have any approaches? I'm just interested in your thoughts.

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

Look, obviously, our job is to run this business, to invest in it, to develop the products, deliver for our customers, deliver for our colleagues and make this transition from an on-premise license business to a cloud native -- to a higher-growing cloud native business, and that's exactly what we're doing. We're doing that whilst maintaining a strong balance sheet, and we're doing that whilst giving good shareholder returns.

We are confident that this business can continue to develop along the lines that you've seen over the last year and certainly in Q1. We're also confident that we've got the resources to be able to invest in the business for the medium to longer term. And we have a strong balance sheet to weather any of the economic uncertainties that all businesses are facing at the moment. That is our priority. But of course, though, we, as a Board of Directors, fully understand our responsibilities with regards to shareholder value, and we'll look at all avenues that are available to us as appropriate. I can confirm we have had no approaches for the group.

Operator

I will now hand back the conference over to Mr. Howell for the closing remarks.

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

Just to say to everybody, thank you very much indeed for your questions. If you do want to have any follow-up discussions or questions, please do get in touch with James or myself. Thank you very much indeed.

Operator

That concludes the conference for today. Thank you for participating. You may all disconnect.