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Q3 2019 Sage Group PLC Trading Statement Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and thank you for standing by. Welcome to today's Sage Group Q3 Trading Update Conference Call. (Operator Instructions) I must advise you that this conference is being recorded today on Thursday, the 25th of July, 2019. Your presenters today will be Jonathan Howell, CFO; who's joined by Lauren Wholley, Head of Investor Relations.

I would now like to turn the conference over to your presenter today, Jonathan Howell. Please go ahead, sir.

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

Good morning, everyone, and thank you very much. And welcome to the Sage Q3 trading update. First, I'll give you a quick update on the key numbers and then we can open for Q&A.

Total revenue for the first 9 months of the year is up 5.9% to GBP 1.4 billion. Recurring revenue increased by 10.6% to GBP 1.2 billion, and this is underpinned by growth in software subscription of 28% to GBP 752 million. This strength in recurring revenue reflects our focus on acquisition of new customers and migration of existing customers to subscription on our cloud-native and cloud-connected solutions.

It's worth noting that recurring revenue growth has been assisted by a weaker comparator in the prior year and also by Making Tax Digital in the U.K., which has attracted both new and existing customers to the latest version of our software. Separately, the combined decline in SSRS and processing revenue was 13%. This reflects the continued migration to subscription, but also some underperformance in X3 licenses and services mainly in France and in the U.S.

Looking now at the major regions. North America delivered total revenue growth of 10% to GBP 471 million and recurring revenue growth of 12%. Growth in this region continues to be driven by cloud connected solutions on Sage 50 and Sage 200 and also Sage Intacct. The UKI continued its strong recovery with total revenue growth of 7% to GBP 300 million and recurring revenue growth of 16%. This is largely due to continuing progress in Sage 50 cloud connected migrations.

France delivered total revenue growth of 2% to GBP 206 million and recurring revenue growth of 5% driven by Sage 200 Cloud. We look now at the portfolio view of revenue. Growth in group recurring revenue of 10.6% for the first 9 months is being driven by the future Sage business cloud opportunity where recurring revenue increased by 12.7% to GBP 1 billion.

As a reminder, this portfolio consists of cloud native and cloud connected products in Sage Business Cloud as well as those products that become part of Sage Business Cloud over time. Recurring revenue in the other portfolio was flat, which is in line with our expectations.

So in summary, Sage's vision is to become a great SaaS company and the further strong performance in recurring revenue shows that we are making good progress. And so finally, an update on guidance. We expect full year recurring revenue growth to slightly exceed guidance of 8% to 9% and the combined decline in SSRS and processing revenue to be slightly greater than the decline seen in the first 9 months. Also we expect organic operating profit margin to be at the lower end of the range of 23% to 25%.

Thank you. So now let's open for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Stacy Pollard from JPMorgan.

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

A couple of quick ones. Maybe you could -- or could you help us with the net impact at the revenue line? I mean I think we previously calculated something like 5% to 7% like-for-like revenue growth overall based on the original guidance. Can you maybe give us a hint at where that goes after these changes?

Secondly, looking -- digging in on the margin, going to the lower end of the guidance, is that a function of revenue mix or a step-up in investments? And then how does that kind of set you up as you go into fiscal year '20? How do you anticipate that looking?

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

Yes. So first of all, in terms of margin, the guidance that we've given is within the range that we set out at the beginning of year. So at the beginning of the year, we said 23% to 25%. We reported that H2, 23.2%. And we guided down towards the bottom of the range for the full year. And in response to your question, is that the combined investment? The investment is being phased evenly throughout the year, this year. We've given no guidance about phasing in terms of margin. And the impact is almost entirely down to the decline in SSRS, which is obviously in the announcement.

In terms of total revenue, at the beginning of the year, we didn't guide explicitly to total revenue at all. We just guided to recurring revenue at SSRS and processing revenue decline. But the market arrived at sort of an implied range that, that would be for total revenue in something because you have said it was just about 5% to 7%. And as you can see that we are sort of tracking within that range in terms of total revenue growth for the full year. But the focus for us in revenue is very much execution on the strategy and its recurring revenue, and that is that bit that -- is now sort of 84% of the revenue mix is absolutely the revenue that's aligned to the strategy that we're implementing, and that's being underpinned by the 28% growth in subscription. So all in all, the total revenue line is tracking where we anticipated at the beginning of the year, and we believe we'll consistently stay within that sort of range that you mentioned.

Operator

And your next question comes from the line of Amit Harchandani from Citigroup.

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

Amit Harchandani from Citi. Firstly, if I may, going back to the recurring revenue growth dynamics, I mean clear acceleration. Could you maybe talk about what does it mean in terms of penetration for subscription? And how do you see that evolving maybe early signs going into 2020? Any particular product that you want to call out and areas where you see room for further acceleration? And I have a second question.

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

Yes. So I think the key thing in terms of the sort of the metrics, first of all, as you can see, subscription revenue, 28% at the Q3 stage, very much in line with what we reported at H1. I can confirm that Intacct at the Q3 stage is again very much in line with what we reported at H1. And in terms of penetration, at H1, we reported 52% and that's continued to move up to 53%; and the penetration of Sage Business Cloud, which was 44%, is now at about 46% in those broad terms. And it's worth saying that another key metric for us, which was, if you recall, at H1, which was the growth of recurring revenue in the Sage Business Cloud, that's both cloud connected and native cloud, was about 85%. And I can confirm in the Q3 stage, in broad terms, we're about that 85% growth rate in the Sage Business Cloud still. So those key strong metrics that we saw in H1 was -- we haven't sort of identified them item by item here in the announcement. I can confirm the Q3 stage are very consistent both in cloud connected and native cloud.

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

And secondly if I may, I appreciate you would not like to give us a formal guidance for 2020 or beyond, but as we look at 2019, on one hand you have a revenue dynamic where recurring is quite strong benefiting from low comps. On the other hand, the weakness in SSRS seems to have weighed in on your margin trajectory. As we look beyond that, assuming a normalization or a reversal of some of these trends, would you assume recurring revenue growth to maybe slow down simply because of the base effect going into 2020? But on the other hand, margin improvement should be better because of potentially easier comps for SSRS going into 2020? Any thoughts in terms of how we could think beyond FY '19 if you could share at this stage would be...

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

Yes. Thank you, Amit. And first of all, I'll preface the answer by saying that throughout the course of this year at Q1 and H1 and now, we're not giving guidance for FY '20 or indeed, midterm guidance. And that was something that we've historically done, but we haven't done this year. What I can say to help though in relation to FY '20 is that recurring revenue growth that we've seen at 10.6% so far is strong. That outperformance has been consistent and indeed accelerated in recurring revenue during the course of the year from Q1 to H1, now to Q3. And that's driven -- being driven by good execution. But also, we have taken the benefit of some tailwinds, which we called out in the announcement. One of those is that we're simply running against a soft comparator. Throughout last year, SSRS was the principal focus in driving license and services growth, and that, therefore, reduced the recurring revenue opportunity and the recurring revenue that we reported during the course of last year. And so we're running against a soft comparator.

And then secondly, in one of our territories in the U.K., Making Tax Digital has given us a benefit. Now we're not going to report on sort of estimations of what those could be. But what I do urge you to do is to sort of take those into account and consider without those, there would be a lower rate of recurring revenue growth, but albeit it would be good and we would be very happy with it. And so therefore, looking to FY '20, those tailwinds in recurring revenue will substantially not be there next year. And so I think it's important that when looking at this year's performance to date when we get to the year end, that a clear adjustment is made for the full 12 months in relation to those tailwinds that we've had this year.

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

And any comments on the margin evolution going into 2020?

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

Margin evolution. I think the first thing to say about margin just to see after next year is that I think historically, Sage -- we've sort of improved margin in the second half. This year, we've given no guidance in relation to margin and we've spread -- we very consciously spread investment spend and go-to-market spend evenly throughout the year. And so therefore, what we've seen at H1 is consistent with being at the bottom end of the range of the margin for the full year.

In terms of margin for next year, we will continue to invest in growth and in R&D. We haven't set our guidance for next year, but the overall business model will be consistent with the focus on recurring revenue and subscription and the focus on this increased level of investment, which again, we would anticipate wanting to spread throughout the year. So it would be consistent that they're going up. As I say, we're not -- we're specifically not giving guidance for next year. And so we've been right away through all of our planning this year and right away through towards the end of Q4.

Operator

Your next question comes from the line of Mohammed Moawalla from Goldman Sachs.

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

First question is just on X3. Can you just drill into sort of the surface of the weakness there? Did you experience sort of deal slippages at the end of the quarter? And if that's the case, have those subsequently closed?

And then secondly, just as we think about the investment plan, I mean you talked about kind of the phased investment this year. But as we look towards next year, this year, do you expect kind of to maintain in that sort of margin range? Or you're more likely to kind of stay at that, the lower band, your margin's still flattish into 2020?

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

Yes. Okay. First of all, in relation to SSRS and specifically X3, first of all, what we're seeing again, we saw SSRS revenue down at Q1. We saw it down a bit further at H1. And now going into Q3, that SSRS decline has continued. And basically, I wouldn't like to call out any one specific. It's underperformance against the strong comparator. And to be honest, it's also underperformance against our original plans that we were setting about 12 months ago. We're on it, we're looking at it. And as you can see from the guidance, we expect that to continue to the last quarter of this year. But there's nothing in particular, no one thing that I'd like to call out as being the key driver for that decline. And then in terms of margin, the clear commitment that we have was at the beginning of this financial year in November '18, the FY '18 results, we've had set out the increased level of investment that we wanted to make going forward and the margin impact but that, [that had]. And we have delivered on that during the course of this year, and our expectation is that we will be delivering in a similar way at a similar type of margin going forward.

Operator

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

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

It's obviously very strong recurring revenue growth, and you've called out a couple of tailwinds you've had from soft comps and Making Tax Digital. Can you actually quantify how much of the SSRS license you've actually moved from a traditional license that's also flattered the recurring revenue growth? And with that in mind, can you give us the split of what's remaining in SSRS between license and service to see how much of a benefit you've got to come in the future?

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

Yes. I think, first of all, in terms of the soft comps and SSRS, the -- one of the things -- the backdrop is that organizationally and in terms of strategy and alignment of colleagues with the strategy, the focus is on recurring revenue and subscription. And therefore, at the margins honestly, before -- as the backdrop, SSRS is likely to suffer. In the specifics, have we sort of redirected SSRS revenue to recurring revenue? And has there been sort of a substitution effect? At the margins, yes. But actually fundamentally, it is a step for revenue stream relating to X3 with a separate go-to-market. So fundamentally, no, there has not been a material substitution effect between SSRS and recurring revenue this year. And so I mean in terms of your last question, in very, very broad terms, what's the split of SSRS at the moment? In very broad terms, it's about 1/3 license and it's about 2/3 professional services and other services.

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

And just as a follow-up, I actually can't remember a period where Sage hasn't talked about wanting stronger performance in X3. Rather than this being a sales issue, is there a fundamental product issue?

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

No. It's a good product. It's a product that we have been successful in a range of territories around the world. We are on looking at how we can improve that performance. But again, I will just keep referring us back to the underlying strategy of the organization at the moment, which is very much subscription, recurring revenue, native cloud and cloud connected and moving business into the Sage Business Cloud. And that is where the investment, the focus and the alignment between colleagues and customers has been taking place during the course of the year.

Operator

And your next question comes from the line of James Goodman from Barclays.

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

So just a couple of questions for me, please. The first one on the margin. The guidance tweaked to the lower end for the full year. I think you attribute that entirely to the SSRS decline. But as you said in your earlier comments, the revenue line overall is tracking largely where you anticipated. And from a drop-through perspective, I've always thought about revenue as revenue for Sage. So can you help us a little bit with the additional associated costs to the subscription line versus the SSRS line, why that drop-through is so different given we're broadly where you expected? And help us, therefore, to understand the implied decline, I guess, in the second half margin year-on-year. That's the first question.

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

No, that's fine. Okay. So James, in terms of -- as I said, the important thing to say is that in terms of the guidance that we've given, we're just reflecting sort of facts and say at H1, we reported 23.2%. We're tracking at that bottom end of the range that we set 12 months ago for the market. And we -- and the really important thing to understand, I think I mentioned it already on the call, but just to say that our investments have been phased equally throughout the year and we've given no guidance about phasing. So what we're seeing in terms of the margin is very much as one would expect. There could have been some margin improvement in relation to SSRS revenue, which would have taken our total revenue line up, which would have -- which would improve the margin. But as you can see, the underperformance in SSRS at the Q3 stage has accelerated from H1. And so therefore, that has been a headwind on that margin recovering slightly in the back half of the year.

And in terms of the drop-through, the license bit of the SSRS revenue is very straightforward. The service revenue and professional services and learning services is slightly different in that we have professional colleagues in our teams waiting for implementation and learning services. And if those are not coming through in the revenue line, those costs are still there and need to be there. They are effectively colleague cost, which is clearly different from sort of subscription and the small segment of our business, Sage 50 or whatever, where it's -- the marginal costs of sale are very, very much more reduced. So that does have -- professional services and learning services does have a slightly greater impact on margin. Does that help?

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

Yes. That is helpful. And I just -- it's related to that, that I wanted to ask, I guess, the investment for a follow-up question a slightly different way. I mean as a proxy for that, can you help us at all with your hiring plans overall within that GBP 40 million R&D budget that you set back when the guidance was set? And maybe where we are on the hiring so that we can sort of think about the run rate of our [plans].

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

We are running at that -- the required run rate to meet that additional level of expenditure, the additional level of investments. And so therefore, if you recall at the back end of last year when we reported a margin of 27%, the new look forward that we had in terms of increased investments in colleagues, customers and innovation has meant that we are running -- we very rapidly got up to that required run rate. And that's reflected in the margin, which we set out at 23% to 25%. And that margin would be just slightly higher, to your point, if SSRS revenue hadn't declined as much as it had, say, in the last quarter or so.

Operator

And 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***

Just sort of going back to X3. Can you identify what the causes of the weakness are? Would you say any of it relates to macro? I mean one of the countries you didn't talk about perhaps which is -- is relatively meaningful is Germany. Some of the macro data there has been poorer. I know X3 gets a lot of its sales from France. Could you comment on that? And then I have another one.

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

Yes. So on macro, I mean nothing in particular. I mean our largest territories for X3 have traditionally been with U.S. and France. Those -- neither of those -- do we believe there's a macro impact? And Germany was an important market to us. It's not necessarily one of our larger X3 markets, obviously. And so, as I said to an earlier question, we are looking to -- we are on it, but there's no one particular thing, whether it's sort of go-to-market, marketing, pipeline, product capability, there's nothing specific that I'd like to tell you that this is the particular reason for this underperformance. We just also got to put it into context. This is an underperformance against very strong comparators, an underperformance against a plan that was set over 12 months ago whilst the organization has been accelerating its focus and resources and investment towards recurring revenue, and that recurring revenue is now at 85% of our total revenue line and is the one that is outperforming. And I really do want to sort of put that in context, the size of our performance in recurring revenue exceeds that in SSRS.

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

Okay. And then just on the shift to subscription. If I look at the first half at least, very good performance in the Anglo-Saxon speaking countries or English-speaking countries. And looking at Continental Europe, there's a lower penetration rate and a lower growth rate. Is that something you think is structural? Is it something you acknowledge might be something that needs to be addressed if you're going to sustain the growth rates you currently see given the penetration rates in North America or in U.K., Ireland are much higher on subscription?

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

Yes. Yes. I mean there -- obviously, we have had benefit from migrations during the course of this year. But we mustn't underplay the extent of NCA, particularly in native cloud and in some of our important products, Sage 50, Sage 200, and obviously cross-sell and up sell. So the performance that we're seeing, yes, there is some impact from migration but we -- as we said -- we say in the announcements and we said at H1, we're seeing all aspects of revenue improvement. Your question is right, it's right where it should be. In the U.S. and the Anglo-Saxon countries, in North America, we've got more to do on Sage 200 in the U.S. and a lot more to do on Sage 50 in Canada. In the U.K., we're significantly advancing Sage 50 but still have more to do. And then exactly to your point, when you get to France and Iberia and other European countries, they are -- there's a long way to go. We've hardly started in the migration process there. And that has nothing to do with the product, our customer base or our strategy. That's really to do that we can only move or should be moving in step with the level of cloud adoption in those particular countries. And by definition, it started. And we've got customers at the front of the curve, particularly in France who are wanting to move to the cloud but it will take time as -- in that territory for that to pick up. And that's very consistent with what we've been saying that 2Q people don't, try not to look at us on a quarter-by-quarter basis. This is a multiyear transition. We're doing it with multiple products across 25 territories. And therefore, try and look to a more gradual smooth trend because we are going to have some quarters and some halves that are very good as a particular wave of migration comes through or particular wave of sort of cloud adoption or native cloud product comes through. And then we're going to have other quarters and other halves that just aren't as good. But for you and for us to sort of look at, is that consistent with the strategy? And is this going overall at an appropriate pace?

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

Okay. Just the last one then. Thinking about cash flow, you had a very good first half. I would would've assumed that if there's a mix shift towards subscription, it should be positive because [it was actually paid upfront] to be a good cash flow in the year.

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

Yes. So the -- 2 things on cash flow. It was very strong. And normally, we sort of trend around 100%. And at H1, we were around 150%. And there were 2 reasons for that really: one was the receivables are lower. And with the move to subscription and away from SSRS, you get better and earlier cash collection. And also, we put a focus on cash collection as well in the first half. And then also as the performance of the organization on ARR in particular has come through, that means there are sort of higher bonus accruals this year than last year just to -- in line with the performance. So that trend was very much the first half. However, as we said at the first half, it will begin to trend back down because once you have reached a new higher level of cash collection, you have to continue to hold that higher level of cash collection just to remain at 100%. And so therefore, we do anticipate that during the course of the second half, it will trend down. At this stage, at the Q3 stage, I can still say the cash collection was very strong, but not quite as high as we were at H1, and that's completely consistent with what we said at H1. And we'll see that continue to sort of come back during the course of the second half.

Operator

And our final question today comes from the line of John King from Bank of America.

John Peter King ***BofA Merrill Lynch, Research Division - Research Analyst***

So just a question on the, I guess, the product renovation you're doing, and particularly, you're porting Intacct into the U.K. and Australia. Could you update us on how that project is going? And is there any other R&D projects that may become relevant as we think about kind of the transition towards cloud native solutions over the next kind of 12 to 24 months?

Jonathan A. G. Howell ***The Sage Group plc - CFO & Director***

Yes. So, yes. Thank you, John, and good question. Just to confirm that Sage Intacct internationalization is on track for Australia. We will go live before the end of the financial year. And for the U.K., we are on track to go live at the end of the calendar year. So completely in line with what we said previously.

And then secondly, in terms of additional R&D and ongoing investment, we will give a full update at the year end. But clearly, we are focused on identifying and developing the critical elements of native cloud product that we require, not least in those important areas like in Sage 50 in particular. And we will give you an update on that at the full year.

Okay. Just to say thank you very much indeed, everybody. That obviously concludes the Q&A session for now. But if any of you at all have follow-up questions or queries, do please contract -- contact either myself or Lauren. We'd be very happy to help. Thank you.

Operator

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