Sage Q3 Trading Update

Thursday, 29th July 2021

Operator

Good morning, everyone, welcome to the Q3 Trading Update Call for the Sage Group Plc. 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 Mr Howell. Please, go ahead, sir.

Trading Update

Jonathan Howell

Chief Financial Officer, Sage Group Plc

Introduction

Thank you very much. Good morning, everybody, and welcome to Sage's Q3 trading update. First, I'll run through the key numbers and 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.

Overview

Sage performed strongly in the first nine months. We delivered recurring revenue growth of 5% to over £1.2 billion, supported by software subscription growth of 11% to £920 million. And this means subscription penetration increased to 69%, up from 64% last year.

Regional performance

Regionally, North America grew recurring revenue by 7% to £475 million, driven mainly by good performance from Sage Intact. In Northern Europe recurring revenue grew by 4% to £292 million. This reflects accelerating growth in cloud native solutions, including Sage Accounting, and also further growth in Sage 50 cloud connected. And in the international region, recurring revenue also grew by 4% to £454 million with particular strength in cloud connected.

Portfolio revenue

Looking at the portfolio view, recurring revenue for the Future Sage Business Cloud Opportunity increased by 7% to over £1.1 billion. This was underpinned by strong growth in cloud native revenue of 32% to £205 million, mainly through new customer acquisition and supported by migrations to both cloud native and cloud connected solutions. As a result, Sage Business Cloud penetration increased to 66%, which is up from 60% last year.

And finally, recurring revenue in the Other portfolio was down by 11%, in line with our strategy.

Q3 highlights

Moving on to the third quarter, recurring revenue grew by 6% to £409 million, driven principally by cloud native growth of 37%, together with continued growth in cloud connected. This was strengthened by our programme of additional strategic investment in sales, marketing and innovation.

Other revenue

Now, turning to Other revenue. This decreased by 18% to £109 million, in line with expectations. And as a result, total revenue grew by 2.6% to over £1.3 billion, and for Q3, this growth was 5% to £440 million.

Outlook

Now, finishing on the outlook. Following our strong performance in the third quarter, we now expect full year recurring revenue growth to be slightly above our previous guidance range of 3-5%. The Group's guidance across all other metrics remains unchanged.

And so, to summarise, we delivered a strong performance in the first nine months as momentum in the business continues to strengthen.

Thank you, and now let's open for questions.

Q&A

Operator: Thank you. We will now begin the question-and-answer session. To ask a question over the audio, press star one on your telephone keypad and wait for your name to be announced. To cancel your request, kindly press the # key. Once again, star one if you have any questions.

Question is from the line of Adam Wood from Morgan Stanley. You may ask your questions.

Adam Wood (Morgan Stanley): Thank you. I've got two, please. First of all, obviously, another nice raise in the guidance for the full year. I wonder if you could just talk about what you're seeing there? So, I imagine the business was really a little bit better than expected in the third quarter. Could you also, more importantly, what you're seeing on the leading indicators, particularly around any kind of comments on ARR, what you're seeing on new customer acquisitions there? Could you give us a feel for what you think the run rate might be for the end of the year on that metric?

And then, secondly, again, another nice acceleration in the cloud native business. Could you talk there, you know, what's happening in terms of the different products contributing to that, and maybe specifically on Intacct, where you're seeing migrations from in that business? Thank you.

Jonathan Howell: Adam, thanks very much indeed. For of all, as you say, we – this is a very consistent performance with what we reported for the first half. The lines of the business that were doing well at the first half stage have continued to do well during the course of Q3, and effectively, all we're seeing is a moving forward of the numbers by another three months. We've slightly outperformed our expectations, and as you can see, in the year-to-date, recurring revenue grew at 5% for the full nine-month period. For Q3 standalone, we grew at 6.1%.

The, you know, to answer the question around ARR progression, which the leading indicator, at the first half stage, we indicated that we were at the bottom of the decline in the growth of ARR, and so, we reported 4.2% ARR growth at the first half stage. What we're seeing now, as we expected, and as we signalled, is an acceleration in ARR growth. And just to give you a sort of a feel, if we're raising our full year guidance for the year, which we are, to slightly above the 3-5% range, then as you would expect, ARR as the leading indicator will exit FY21 at a faster growth rate than that.

Just to give a little bit more colour on sequential growth, we are seeing sequential growth now. As you can see, at the Q3 stage, on a constant currency basis for recurring revenue, sequential growth was about 2%. Q2 was about 1%, and Q1 it was about 1% as well. So sequential growth in recurring revenue, we're seeing an increase there, but it was almost double what we were seeing at the first half stage.

In terms of products, it's the same products that we reported on that are driving this growth. Cloud native grew at 32% during the nine-month period. The principle driver of that is Sage Intacct in terms of volume and value in the US, but very strong additions coming in Sage Accounting, particularly in the UK, Sage People, AutoEntry, and SageHR. So, all of those are continuing to grow and to accelerate in terms of the growth rate. And just to put in context, as you know, Intacct, we reported in the US grew at 19% at the half year stage. It is now growing faster than that. But, importantly, the other portfolio of cloud native products, in order to get to a 32% growth rate, are therefore growing considerably faster than Sage Intacct. And all in all, we see a firm upwards trajectory in the growth rate of cloud native.

Adam Wood: That's very helpful, thank you very much.

Operator: Thank you. Our next question is from the line of Ben Castillo-Bernaus from Exane BNP Paribas. Your line is now open.

Ben Castillo-Bernaus (Exane BNP Paribas): Hi, good morning, thanks for taking my question. A question following on from the last one, the trajectory you expect in H2, you know, your expectations for a continued sequential acceleration like you've seen Q3 over Q2 and Q1, or is it plateauing there?

Second question would be, could you just recap the expansion of the Sage Partner Cloud announced last week, and what that will enable. What are your future plans and expectations, particularly in regard to, sort of, hyperscale infrastructure, I think as was mentioned in that press release?

And then lastly, if you could just touch on margins, you know, how you're thinking about the trade-off between your discretionary marketing spend for the rest of this year and into 2022, given the solid results you've seen so far this year, and how you're thinking about that? Thank you.

Jonathan Howell: Yes, thanks very much. First of all, on more colour on growth rates into the second half, you know, we've given clear guidance for the full year. We're moving into the last quarter, so it's just, sort of, fine-tuning at this stage. I think one additional bit of colour is on ARR growth. We don’t report ARR at the Q1 or the Q3 stage, only at the half year and the full year, but I can give you a bit of colour. Sequentially, in Q3 it grew at 2.5%. Sequentially Q2, 2%, and sequentially Q1, 1%. And that's just drawing out the trend line that we described at the half year stage, and just putting a few little proof points on that.

Sage Partner Cloud, yes, that's an important development for us in our major territories – France, UK, and North America in particular – taking the old BMS franchise and moving that into a trusted environment, either managed by Sage ourselves or one of our major partners. It has started well in Europe. The uptake is now just beginning to come through as well in

North America. And to put some colour on the migrations from cloud connected, this is effectively Sage 200 and other products into cloud native, of that growth of 32% that you see at the nine-month stage in cloud native, about a quarter of it comes from migrations. And some of that is Sage Partner Cloud, some of that is moving to Sage HR, which is our cloud native HR solution, and some of it is also as reported, although not too material at this stage, is movement from Sage 50cloud connected to Intacct, where we're seeing that beginning to happen in the UK and North America.

And then your last question around margin. You know, as revenue growth is ramping in the second half, therefore our speed of spend is also ramping just to, sort of, fall in line with the guidance that we set at the beginning of the year, which we reiterated at the first half stage, and we're now reiterating at Q3, very consistent story, is that we anticipate that this additional spend will move the margin up to three percentage points lower than where we were at the end of FY20. And again, it's going to exactly the same places that we highlighted at H1, which is product, and R&D, and also sales and marketing. Those have been the big beneficiaries of the reduced – of the increased investment, and that, you know, and you can see the acceleration in cloud native NCA and up-sell and cross-sell, which we reported today. Thank you.

Ben Castillo-Bernaus: Thank you very much.

Operator: Our next question is from the line of Will Wallis from Numis.

Will Wallis (Numis Securities): Morning, thank you. I want to ask a quick question about the growth rate. Are there any base effects in there? So, for example, on a year-on-year basis, when you're looking back a year, had you been giving anyone discounts, for example, in the recurring revenue line that means that there's been a, sort of, one-off improvement that's not sustainable as you've moved back to normal pricing – and that's a question both on a year-on-year basis and also if you're looking at your ARR for the Q3 versus Q2, that 2.5% growth rate sounds very impressive, is there any sort of base effect there as well?

Jonathan Howell: Yes, very good question. I think there are just two things to be aware of, in terms of year-on-year comparators, one was, if you recall, Q3 last year was the first quarter that we operated in post the beginning of the lockdowns in our major territories. And if you recall that in April last year, we reported that NCA levels were running at about 60% of what they were on a pre-COVID basis. So the first month or so, you know, the first month at least of this quarter was severely impacted by the advent of lockdowns and government restrictions in relation to COVID. However, if you recall, by the end of the year, by the end of the last financial year, we reported that NCA levels were at about 80-90% of what they'd been on a pre-COVID basis, so a very rapid recovery during the course of last year, second half.

In that context, it is a slightly weaker quarter that we've got as a comparator in Q3 last year. But I'll hasten to add, it was nonetheless quite strong. So, we just reported a 6.1% recurring revenue growth in Q3 this year; it was 6.5% last year. So the overall growth rates were not too dissimilar. The big different was the growth rate at this stage last year was declining, the growth rate this year is clearly accelerating.

So, a little bit of an impact on comparators being lapped, but not too much.

And then, secondly, in terms of pricing, this has been a year of very few price increases across the whole portfolio, a modest impact. There have been one or two isolated areas. For instance, in the UK, we had the unwind of pricing discounts which had an impact. But if you take the whole portfolio across the whole Group, a very, very limited impact from pricing during the course of this year, and so that should not be factored into. Thank you.

Will Wallis: Just to come back, did you give any, sort of, holidays – payment holidays to any of your customers at the beginning of the pandemic which have now effectively gone away, because the customers are still there and now paying properly and therefore that that's helping the growth rate?

Jonathan Howell: Will, a good question, and it's probably worthwhile just updating the commentary on that. So if you recall, Q3 last year, full year last year, and H1 this year, again, it was a very consistent story – we were offering our customers payment holidays or deferred credit terms on a case by case basis where we think that would make a real beneficial impact to a customer, and was something that we wanted to do. The uptake on that was very, very low across our customer base. And I can give continuous report that the uptake is still very low, and the impact on the reported numbers last year, and this year, is completely not material.

Will Wallis: Great, thank you.

Operator: Our next question is from the line of Stacy Pollard from JP Morgan.

Stacy Pollard (JP Morgan): Hi, thank you for taking my questions – two from me. You touched on ARR exiting the year. How do you think about mid-term sustainable revenue growth rate? Do you think that the previous pre-pandemic rate of, sort of, 7-8% growth are realistic in the mid-term?

And secondly, how have measured or seen the success of your additional spend? So you've obviously been accelerating the business throughout this year. You're continuing to make the investments that you wanted for this year because of that success. Do you think you're now at the right level of investment base, meaning, that kind of further top-line acceleration would actually drop through to margins more aggressively starting from next year?

Jonathan Howell: Yeah. So, I think just in terms of the investment and return on investment, it's – you know, we've had a marked step up in investment over the last 18 months. You know, we've kept you abreast of the significant increases, particularly in product and R&D, which is now at 17% of recurring revenue, and similarly, sales and marketing are 42%. And then, literally, you know, with a lag of about a quarter or so, we're seeing this uptick in growth rate, particularly in cloud native, where we're running at 37% of growth in cloud native in Q3, with the fastest parts of the portfolio growth coming from non-Intacct. That is obviously measured against our normal ROI, LTV, LTV-to-CAC, and all of it is value generative for the business. And we will continue to invest but only if we believe it is value generative and is the right thing to do for the medium-term of the business.

And in terms of trajectory, as we've said in the past, you know, we've got a nice problem at the moment, is that we're accelerating investment as growth accelerates. However, as we move forward into FY22 and FY23, our lead objective is growth in cloud native and growth in Sage Business Cloud, and then our second objective – and only over time – will be to very gradually improve the margin. So it will be growth-led and not, sort of, margin-led as we come through the next two years or so.

In terms of medium-term growth rates, I think if you go back 2-3 years, when we started this transition, sort of, second quarter – first, second quarter FY19, one of the things that we cautioned against was extrapolating too much into immediate short-term growth rates. And the reason for that was that we have a portfolio across in small and medium segments, across a good number of territories with very different customer and characteristics, and therefore we knew that some period of transition of the portfolio would be very rapid and will give an overperformance in growth rates, and other periods would appear to be getting an underperformance, you know, either side of a medium-term trend.

And we saw exactly that in FY19 and the first half of FY20 when we migrated substantially all of the Sage 50 base and all of the Sage 200 base very rapidly in North America and Northern Europe, which was also assisted by making tax digital, and so, we exited FY20 with an ARR growth rate of about 13%, and I think the UK recurring revenue growth rate was about 15% or 16%. That was an outperformance driven by those very rapid migrations.

We were then, sort of, you know, we have now traded through much of the impact of the COVID environment and the business lockdowns that our customers have experienced and we're heading back to a more normalised growth rate. We don't give medium-term guidance Stacy, but I think one of the things, you know, if you look forward at FY22 consensus, it's around 7% or 8% recurring revenue growth at this stage. That seems a sensible place to be positioned as we come to the back end of FY21 and are, sort of, setting up our jump off point for the next financial year. So when we get to the year end, off the back of that consensus of that 7-8% recurring revenue growth rate for FY22, we will be able to give you some slightly more precise guidance.

Stacy Pollard: That's helpful, thank you.

Operator: The next question is from James Goodman from Barclays.

James Goodman (Barclays): Morning, thanks very much. Firstly, just on the non-recurring business, appreciate a very deliberate strategy there to decrease that line over time, but if I look at a comp, minus 35% last year, I thought it might just bounce a little bit, as some of your services come back. So just wondering if you might still expect that? And maybe if you could just comment on the extent to which there is still any real substitutions still coming out of that line into the recurring line? I appreciate that that's now quite small. So any commentary around the anticipated development of that.

And then, secondly, just on Sage Accounting specifically, I know it was discussed in the past, you know, metrics around this business and you don't want to give precise subscriber numbers. I happened to notice on your website that you're calling out one million business owners on Sage Accounting. So wondered if you could comment on that, whether that's users or you've accelerated to that level of subscribers – anything on the ARPU that we can discern from that, just the progression of that project – product.

And you also mentioned I think just now some migration, a small amount in Sage 50c to Intacct. I suspected you might see a little bit more the other way from Sage 50c to Sage Accounting. So anything on that would be helpful. Thank you.

Jonathan Howell: James, thanks very much. You know, in terms of the Other revenue line, I think in your question you were absolutely spot on. We're now very much in an environment where the priorities of the business in small and medium segment is to build ARR through the cloud native product offerings that we've got. That is one of our most critical and primary objectives that we're delivering on. That is where investment and focus is being placed.

Secondly, is still to move our remaining customer base into the Sage Business Cloud, and that is still growing well in terms of cloud connected. We're still seeing good growth in cloud connected revenues through very good up-sell and cross-sell of the Sage 50 base, particularly in the UK and North America, but also ongoing migrations of Sage 50 Payroll in the UK that's given us momentum this year into cloud connected. And then across the continent into Europe, France and Spain in particular, the migrations are continuing into cloud connected for Sage 50, Sage 200, we're about 60% of the way through that transition.

That is the priority of the business. And absolutely, as you say, the Other revenue line, that is about a third licences and two-thirds professional services, those are not the focus of this business any more, and as we've seen over the last three years, that revenue line will continue to decline. The rate of decline will vary from quarter to quarter but will be ongoing and continuing. The rate of decline was a little bit lower that what we've seen over the last two years in Q3, and that was in particular, and that was up against the Q3 comparators and the NCA discussion that I just had earlier in the call.

So don't read too much into Q3, that revenue line will continue to decline. It is now, I think if you look at the Q3 numbers, 7% or just below 7% of total revenue, and so is really not a material driver on, you know, of our results or our growth rate.

And then in terms of Sage Accounting, yes, as you said, we are focussing on a sustainable, balanced ARR growth of Sage Accounting across the territories where it is offered to our customer base. That is picking up, that growth rate. As you know, we are not focussed absolutely on sub count, customer count, we're very much more focussed on the professional user with a higher ACV and lower churn rates, and that is driving our strategy and go to market, and also product upgrades. It's made a good start. The only guidance that I can give you is that it is growing faster than Intacct. That portfolio outside of Intacct is growing significantly faster and we are very pleased with the progress to date.

But, as you say, we don't, given the number of products and territories that we operate in. We're not breaking that into an individual sub count or ACV by product, by territory. We will have a very big spreadsheet if I did that.

James Goodman: No, that's helpful. Thank you. Did you say the one million number of users? Did you say that or – just to be clear.

Jonathan Howell: Yes, across the whole portfolio worldwide that is a number that, you know, resonates in terms of our small segment.

James Goodman: Okay, thank you. Excellent.

Operator: Next question is from the line of Paul Kratz from Jefferies.

Paul Kratz (Jefferies): I think, first and foremost, is there any comment you can make around the up-sell and cross-sell components there are? Has that started to recover? And I guess any colour on renewal rates.

The other question I also had as well, I mean, when you look at the R&D and S&M that's picked up pretty meaningfully, but have you also seen an improvement I guess in your customer acquisition economics, and this is basically just more efficient spend driving more efficient growth than you had historically?

And then maybe just two final questions, on Cegid the valuation I think that came out, if I remember which private equity firm, looked pretty punchy, does that maybe change your thoughts on your French business? And then, finally, on NCA in the quarter, it looks like the number is almost as large as what you did in the second half last year. Is that math correct? I mean, any qualification I guess on the size of NCA in the quarter or any comparison versus prior quarters would be helpful. Thanks.

Jonathan Howell: Thanks very much for the questions, there were five there I think, or six, which is probably not fair on your colleagues in the analyst community. So, if you don't mind, we'll take some of them, and the rest we'll take offline, if don't mind.

I think in terms of, you know, you were talking about renewal rates that we've seen across the portfolio, and also cross-sell and up-sell. Renewal rates, if you recall, we, sort of, last year, the first half, we literally were running as per normal, at about 101% renewal rate by value across the whole portfolio. The second half was obviously the impact of COVID, we were running at about 97% renewal rate by value, but was – that was consistent and flat during the second half. It wasn't deteriorating at all, and so therefore, we averaged out over the full 12 months to about 99% overall for the full year.

At the first half, again, we reported 97%, so very much in line. What I can tell you now, is in Q3 year-to-date, we've seen a slight improvement in that. And we believe that that is now beginning to head in the right direction.

Really, really good question around, you know, sort of, cross-sell, up-sell – that is making a difference, particularly in small segment, particularly in the UK and also North America. So customers who are taking the Sage Accounting line are very rapidly moving to taking on Sage HR, which is the cloud native HR solution. They're also taking Sage Payroll in the cloud, AutoEntry, the automated accounting service for making tax digital and submitting your tax digitally, and also bank payments and bank fees. All of those are cloud native products with a very high attach rate coming off Sage Accounting, and so that's a very, very important offering in the Sage Accounting space.

Just remind me of one more, what was your next question, I beg your pardon?

Paul Kratz: I think the most important question on my end is you have increased your investment in R&D and sales and marketing. And I guess any commentary on efficiency of growth or LTV-to-cap, I guess, the economics of the business, has that improved?

Jonathan Howell: Yes. So where we are really ramping up new customer acquisition and ramping up investment, we've seen a flattening or a slight reduction in some of the unit economics as we gain territory and get beachhead into particular customer segments.
However, once that becomes a more established trend and the go-to market is aligned

exactly where we need to, and we're getting benefit from the marketing campaigns that are now becoming much longer established, then we're seeing those unit economics improve.

The one thing, and that was one of the earlier questions, I think from Stacy, is that the one thing that we will not do is invest more money or invest any money where we do not see good unit economics on a SaaS basis, and it's the classic LTV and LTV-to-CAC metrics. We will not do that for the sake of gaining new territory or gaining new customer bases. We will always do it on an economic basis.

Paul Kratz: Perfect, that's very clear. Thank you.

Operator: Thank you. And that's all the time we have for questions. I will now hand the call over to Mr Howell for closing remarks.

Jonathan Howell: Yes. Thank you very much indeed for attending today. Thank you for your good questions as ever, and absolutely the right questions off the back of the announcement. James Sandford and the IR team and I will be fully available today for any further questions that you'd like to leave. Thank you.

Operator: Thank you. That concludes our conference for today. You may all disconnect. Thank you all for participating.

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