# Sage Group plc Q3 Trading Update

Tuesday, 2nd August 2022

**Operator:** Good morning, everyone. Welcome to the Q3 trading updating 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. After the speaker's presentation, there will be a question and an answer session. To ask a question you will need to press star one and one to ask a question. I would now like to hand the conference over to Mr Howell. Please go ahead.

## Q3 Key Numbers and Performance

Jonathan Howell

*Chief Financial Officer, Sage Group plc*

Thank you very much. Good morning, everyone 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. And, as a reminder, all numbers in the trading statement are on an organic basis.

### Strong Performance

*Delivered against strategic priorities*

Sage performed strongly in the first nine months as we continued to deliver against our strategic priorities. Recurring revenue increased by 9% to over £1.3 billion, driven by Sage Business Cloud growth of 20% to £886 million. Software subscription revenue grew by 14% to £1.1 billion. As a result, three-quarters of our total revenue is now on subscription, up from 69% last year.

*Regional performance*

Regionally, North America increased recurring revenue by 13%, with accelerating growth in Sage Intacct, together with growth in cloud connected. In Northern Europe, recurring revenue grew by 7%. This was driven by continued success in cloud-native solutions – in particular, Sage Accounting, Sage Intacct and Sage HR – and was supported by good levels of growth in Sage 50 cloud connected. And in the international region, recurring revenue grew by 5%, with growth across the Sage Business Cloud. This was supported by further progress in migrations.

*Portfolio view*

Looking at the portfolio view, recurring revenue for the Future Sage Business Cloud Opportunity increased by 11% to over £1.2 billion. This was underpinned by a strong performance in cloud native, where recurring revenue grew by 42% to £297 million. This was driven by good levels of new customer acquisition. And cloud connected has also continued to grow strongly through both new customer acquisition and further progress in migrations, and, as a result, Sage Business Cloud penetration has increased to 72% – this is up from 67% last year – with more customers able to connect to Sage's digital network. Finally, in the non-Sage Business Cloud portfolio, recurring revenue was down by 11%, in line with our strategy.

*Q3 recurring revenue growth*

Now moving on to the third quarter, recurring revenue growth continued to accelerate, increasing by 10% to £464 million, supported by continued investment in sales, marketing and innovation.

*Other revenue*

Now turning to other revenue, which decreased by 25% to £82 million, in line with expectations, and, as a result, total revenue grew by 6% to over £1.4 billion; and, for Q3, this growth was 7% to £488 million.

**Outlook**

*Good momentum*

Finishing on the outlook, we now expect organic recurring revenue growth for FY22 to be towards the top end of our guidance range of 8-9%. Guidance across other metrics remains unchanged. And so, in summary, Sage has delivered a strong performance in the first nine months, entering the final quarter of the year with good momentum.

Thank you. And now let’s open up for questions.

## Q&A

**Operator:** Ladies and gentlemen, we now begin a question and an answer session. If you wish to ask a question, please press star one and one on your telephone. Please stand by, we are taking our first question and it’s from the line of Adam Wood from Morgan Stanley. Please go ahead.

**Adam Wood (Morgan Stanley):** Hi, good morning, Jonathan. Thanks for taking the question. Congratulations on another good quarter. First of all, just on the recurring that’s stepped up, obviously driving that is the ARR. Could you maybe just give us an update on where we are with ARR in the third quarter and how that’s been trending through the year?

And then I guess on the macro side you say in the release that you’re mindful of trends there, but I guess the guidance – the moving to top end of guidance, the fact that you’re mindful and no more than that suggests that you’re not seeing anything on that. Could you maybe just talk a little bit about, you know, trends in the business around renewals and NCA, and so on, just to confirm that? Thank you.

**Jonathan Howell:** Yes. Thank you, Adam, for the question. Yes, as you can see this has been a strong quarter and a good performance for the first nine months. And if we just look at recurring revenue first, how that’s progressed during the year, before we move to ARR. At Q1, we reported recurring revenue growth of just below 8%. At the first half stage we reported recurring revenue slightly above 8%, and now, as you can see, for Q3 year-to-date we’ve reported recurring revenue growth of approaching 9%; and Q3 stand-alone was 10% growth for recurring revenue. And so, you know, by definition, as you know, that means that we are seeing good progressive growth in ARR, and if you just – you know, if I give you a snapshot of where we are, Q3 sequential growth in ARR was 3%, Q2 was 3% and Q1 sequential growth was 2%. That gives you the progression. As you know, we only report ARR at the half-year and the full-year stage, and so, clearly, when we report full-year numbers at the year-end we’ll give you an update then.

In terms of macro, it's very much, you know, as we've said in the release. That performance that we have seen gives us confidence to raise guidance towards the top end of the range of 8-9%, and just to confirm that, at this stage, we have not seen any impact from the macroeconomic environment on our business. So in terms of, you know, upsell and cross-sell, NCA and migrations, those are continuing at the same type of trend and same type of performance that we've seen for much of the year. We are mindful of the outlook, we've given very clear guidance for the full year, and, clearly, as we move through Q4 and into Q1 we'll continue to monitor the performance of the business and update you at the year-end.

**Adam Wood:** Okay, that's very helpful. Thank you.

**Operator:** Thank you for your question. We are now taking our next question, so please stand by. And the next question from Varun Rajwanshi from J.P. Morgan.

**Varun Rajwanshi (J.P. Morgan):** Hi, morning. Thanks for letting me on. I just have one question on your cost base. Can you comment on the progression of your strategic investments – in go-to-market, developing new products, etc. – into the second half? And with the macro deteriorating, how would you think about striking a balance between investments and protecting your margin as we look into next year? Thank you.

**Jonathan Howell:** Yes. In terms of the investment programme, as you know we've reallocated considerable spend to product, R&D and also marketing. That has continued and that is, I think, you know, being demonstrated by the strong growth that we're seeing in cloud native in particular, where for the nine months to date we've seen a 42% growth in recurring revenue, and cloud connected, which is also growing at 12%. And so those are our core product sets, and the growth that you're seeing is being driven by the additional investment.

And I think, just on that, we – you know, we've got a very good product set now across North America and UK/I, but we're now rolling out cloud-native products across the international region. And if you just look back over the last nine to 12 months or so: France, we've got Sage Intacct manufacturing, you know, one of our premier cloud-native products released; Spain, Sage Accounting; Germany, Sage HR, you know, which has been very successful in Northern Europe and North America; and France, we've just launched Sage Active. So that investment is continuing and continuing at pace.

In terms of, sort of, margin, you know, as you know we entered this financial year reporting a margin of 19.3% for FY21. Our guidance was that during the course of FY22 and beyond we would see that margin trend upwards. We've repeated that guidance at Q1 in the first half stage and now at Q3, and we feel confident that we will achieve that margin guidance for FY22. And I note that analyst consensus is around 20% and we feel comfortable with that.

Looking further ahead to FY23, our target is to continue to increase the margin. We will monitor that carefully and, all things being equal, that's very much our target, but we will have to continue to monitor the performance of the business.

**Varun Rajwanshi:** Right, thanks for the colour.

**Operator:** Thank you for your question. We're going, now, to take our next question. It's from the line of James Goodman from Barclays. Please go ahead.

**James Goodman (Barclays):** Morning. Thank you very much. Yeah, encouraging developments on the recurring, on the ARR side. Just to look quickly at the other revenue, which has become very small now. Clearly, in the mix, but still declining very quickly. Just wondered, are we close to stabilisation there now? Is it just the license that's still coming out of that line?

And then, secondly, just on Xero. We've seen freemium products from Xero, perhaps around Making Tax Digital. Just wondered if that's something that you would consider at the Sage Accounting product side? Thank you.

**Jonathan Howell:** Yes. James, thank you very much for the questions. You're absolutely right, you know, in your question, that the other revenue line is now becoming, you know, a significantly much smaller part of our total revenue, it's about 5-6%, and, you know, as you know, for the last four years or so that's been a key part of our strategy, to migrate away from on-premise licenses and professional services. That, you know, has provided us the opportunity and the investment to move the business towards subscription.

So what we've seen in the first nine months of the year is a decline of 25%; that's pretty consistent with what we saw last year. That is also consistent with what we anticipate for Q4 and we do anticipate those – you know, a continued decline in that other revenue line. That, in part, will depend upon, you know, the strategic investments that we make across the rest of the business, you know, and we'll keep you updated.

And then the other part of your question, sorry, that was in relation to…

**James Goodman:** Just in relation to Xero releasing a freemium version of their product and whether you would consider that for Sage Accounting or see that as relevant as we move towards the next phase of Making Tax Digital?

**Jonathan Howell:** Yes, thank you. Thank you, James. First of all, the – if you recall, back in, you know, sort of, FY19 and, you know, Making Tax Digital, the first phase of it in the UK was a very significant driver of our business, and that, because that hit, you know, the Sage 50 cloud-connected base, which is where we are very, very strong in the UK. What we are seeing with the second phase of Making Tax Digital is a move to smaller businesses and over an extended period of time, right the way through to FY24. So it's in smaller businesses and over a much more extended period of time to the deadline, and so, therefore, by definition, it will not have such a material impact on our business and so, therefore, I don't think there's – this is an environment where we will be competing overtly on price; you know that's not our strategy.

I think the other thing that's just worth, you know, pointing out is that we will continue to offer a full range of services, you know, for our small businesses. One of those will be, that we see, you know, increasing around the world, is the digitisation of government and tax-related returns. And so whilst I wouldn't necessarily focus on this one event in the UK, it is a strong and growing secular trend around the world, which is going to be a driver of our business over a number of years into the future.

I hope that helps, James. Thank you.

**James Goodman:** Yeah, it does. Thank you.

**Operator:** Thank you for your question. We're now taking our next question. The next question is from Will Wallis from Numis.

**Will Wallis (Numis Securities):** Morning and thanks for taking the question. I wanted to ask about the growth of your cloud-native business and to what extent are you seeing any acceleration in the amount of migrations impacting on that? And, within that, could you also talk about how Sage Partner Cloud is going?

**Jonathan Howell:** Yes. So the growth that we're seeing in cloud native is driven by, you know, the three key products that we've highlighted. And so these are established trends with established go-to-market in our core territories of North America and Northern Europe which are showing a consistency and developing growth, which is exactly what you would hope from a SaaS business. And so, therefore, Sage Intacct, you know, still at the half-year stage when we last reported Sage Intacct numbers, growing at over 30% in North America, growing at considerably faster rates in the rest of the English-speaking territories that we cover. Sage Accounting, which, again, you know, in our core territories is growing faster than that Sage Intacct number of 30%, and then Sage People. So all of those are continuing to drive growth.

We, importantly, are seeing less of that growth now, quarter-by-quarter, is coming from migrations. And so I think if you go back a couple of quarters or so, we'd probably say about a third of that growth was coming from migrations. It's now less than a quarter, and if you go – you know, if you go back, probably two years or so ago, you'd find at least two-thirds of that was coming from migrations. So we've gone from two-thirds to about a third, you know, a couple of quarters or so ago, down to less than a quarter now. So these are new customers coming through the door and buying our products, and then, importantly, giving us that opportunity to cross-sell and upsell. So I think that's all very good.

Sage Partner Cloud is a very, very small component of that. It's not a key driver, but, nonetheless, in some of our territories is a product that some of our customers want.

Thank you, Will.

**Will Wallis:** Okay.

**Jonathan Howell:** I hope that helps.

**Will Wallis:** Yeah, great. Thanks.

**Operator:** Thank you for your question. We're now taking our next question and it's from the line of Charles Brennan from Jefferies.

**Charles Brennan (Jefferies):** Good morning, good morning, Jonathan. Thanks for taking my question. Two from me, actually. Just, firstly, can I ask you to be a little bit more explicit on your margin comments? Normally for software companies, if we see them delivering incrementally better news on revenues, that normally drops through to incrementally better margins. Should we assume that's the case here or are you using this opportunity to continue to double down on your R&D and sales investments that will limit the scope for margin upside?

And then, secondly, on an unrelated topic, can you just give some context to some of the recent press stories that you've been forcing some of the recent Sage 50 perpetual license customers onto perpetual deals? Thank you.

**Jonathan Howell:** Yes. Thank you, Charlie, two good questions. Look, on margin our guidance is very clear and very consistent. The guidance that we've got now, we first set at the FY20 results and at the FY20 results we said there will be a further step-down in margin in FY21, if you recall. But thereafter, FY22 and beyond, we will be in an environment where we – we'll see margin trend upwards. And so, that's been a very consistent form of our guidance now for 18 months, and that's exactly what you saw at the first half and that's exactly what we're guiding to in the future.

And, to your point, you're absolutely spot on, we will continue to target aggressive investment, particularly in products in R&D and marketing, where we can. We will dynamically increase that investment if we've got the capacity to do so, we will also dynamically reallocate during the course of any period. But underlying and fundamental is we are targeting an environment where the rate of revenue growth exceeds the rate of cost growth and therefore margin will expand, and that is very much part of the model that – you know, of how we want to drive the business going forward. And as we build out that, sort of, cloud-native and cloud-connected base of fewer products in fewer larger, you know, sectors and territories, we will generate the efficiencies to help drive exactly what you just described in the question.

On the Sage 50 question, yes, in some of our territories now we have a very small number of Sage 50 on-premise users. This is a migration strategy which, you know, has been running since the beginning of FY19, so, you know, approaching four years, and we do get to a stage, in some of our territories, where we think it's best and safest for the customer to move to our cloud-connected or cloud-native products; you know, that drives the uptake for them of the best and most up-to-date and safest products, and most compliant products, and it also drives, you know, the efficiencies that we need in our business to address the margin point that you've just asked. I would add, though, you know, we take a very, very careful and long-term view about looking after our customers during this migration process, and that's no different for this very small subset of Sage 50 on-premise license holders. I hope that helps.

**Charles Brennan:** I was going to say, are you able to articulate how much of the Sage 50 base is still on-premise?

**Jonathan Howell:** Well, if we look at our core territories, regions of North America and Northern Europe, substantially over 90% of those Sage 50 customers are in the cloud-connected environment, and more and more are relying on all of those cloud-native modules and services that we provide; Sage HR automated payments, automated digital tax returns, auto-entry. All of those cloud-native modules are actually driving that Sage 50 base as we move forward.

**Charles Brennan:** Perfect, thank you.

**Operator:** Thank you for your question. We're taking, now, the next question, please stand by. The question's from the line of Ben Castillo-Bernaus from Exane BNP Paribas. Please go ahead.

**Ben Castillo-Bernaus (Exane BNP Paribas):** Hi, good morning. Thanks for taking my question. Two, if I may? I'm just curious on the effectiveness, I suppose, of each pound of marketing spend that you're allocating. You obviously had a big lift-off with the 'Boss It' campaign. I'm just curious as to what are those returns on each pound of marketing spend today versus, you know, a year or two ago? Are you seeing signs of that normalising or are those returns still being maintained?

Second question would be on NCA, could you just comment on the activity here? Are you seeing any sign of, sort of, pipelines being delayed or maybe a slight change in the rate of upsell that you're able to lock in? Just curious in the context of other software peers commenting on this. Thanks.

**Jonathan Howell:** Yes. We – good question, Ben, thank you. And, you know, part of the move to being a SaaS business has been the real investment in data and financial reporting of the type of metrics that you would expect for a SaaS business. And there are a whole suite of metrics that we look at and, needless to say, you know, if you want it, sort of, in a snapshot, in a summary, it's LTV to CAC. We monitor that by geography, by segment and by individual product, so we can absolutely see the trends developing. And I can tell you that the LTV to CAC, for all of our products around the world in cloud connected and cloud native, are showing good and positive returns.

In Northern Europe, when we started that heavy investment you could see the LTV to CAC dip slightly, but it's still positive and that is now beginning to pick up. And then if you look at medium segment, particularly Sage Intacct in our core territories, that just builds from a high base and is continuing to build and increase. So we are very comfortable around our ability and the direction of travel of those key SaaS metrics, you know, that model and measure the efficiency of investment.

And then in terms of NCA, I mean very good question and, in short, we have not seen any change. As we sit here today, we have not seen any change in the sales life cycle, in the propensity for cross-sell and upsell. But those are the things that we need to monitor, and, you know, in past, typical macroeconomic times we have seen, you know, a slight delay in CFOs in making that decision to invest in a new product or to, you know, invest in further products, we have not seen that yet. And I think the underlying and critical message is we are being driven by a secular trend at the moment, where businesses, small businesses, are seeking digitisation and software to drive deep and meaningful efficiencies in their businesses and particularly in their back offices, and that is a very strong force which clearly, at the moment, is counteracting, you know, any negative impact from the wider macroeconomic environment.

That's where we sit now. Clearly, you know, we'll monitor it over the next quarter and when we report back in November we can give you an update then. I hope that helps, Ben.

**Ben Castillo-Bernaus:** Thank you.

**Operator:** Thank you for your question. We are taking our next question. The next question is from Michael Briest from UBS. Please go ahead.

**Michael Briest (UBS Investment Bank):** Yeah. Morning Jonathan. A couple from me as well. Just in terms of the guidance on margins. I mean it's very specific in your outlook statement from the interims that it's an organic operating margin and the consensus on the website also shows organic. With the Brightpearl acquisition, would you expect margins to be closer to flat, given that was a loss-making business?

**Jonathan Howell:** That was one question. I think – did you say you had two?

**Michael Briest:** Yes, sure. I'll give you the other one. Just in terms of ARR, I mean so exiting 2020 you did 5%, or you exited with 5% growth, and you guided 3-5% for recurring and did 5%. You exited 8% last year and you're guiding 8-9%, closer to 9%. If you carry on you're going to be, I'd say, 11%, you know, at a push maybe 12% ARR growth exiting this year. You know, should we be thinking about this, sort of, pattern where the subsequent year's recurring revenue growth is pretty closely aligned?

**Jonathan Howell:** Yeah, okay. On the margin, very good question. You know, we do report, as you say, on an organic basis. Brightpearl, you know, some – you know, that acquisition is dilutive to our margin. But, if you recall, at the first half stage, Steve and I were very clear on the call – at the first half stage, Steve and I were very clear on the call, that any margin dilution from acquisitions would be absorbed within our existing cost base. And so, therefore – and it's a very good question that you raise – and therefore it's not going to impact our guidance on margin for this year and beyond, and that – you know, we're very clear on that.

And then secondly, in terms of ARR, you've, you know, nailed it in terms of the ARR build, which then leads to recurring revenue performance. We've got, you know, very clear visibility and confidence to be able to raise guidance, as you said, you know, for the full year. Looking further out into FY23, as you'd expect we'll provide guidance at this year-end results for FY23, but there's a good trend there that you can see during the course of the last 12 months.

**Michael Briest:** Can I just ask a follow-up on pricing? Could you say how much of the ARR progression this year's come from pricing and maybe how much more is likely to come?

**Jonathan Howell:** Yes. In terms of pricing, we – you know, look, first of all, as we said again at the half year this is no different, nothing has really changed. We always – you know, we'll target price increases judiciously and carefully across our customer and product base where we see a fair value exchange, and in Q3 that approach has not changed since the first half at all. As we sit here now, you know, the pricing that we have put through is running at about 3% for a full-year, you know, annualised basis, and we don't anticipate that will change materially during the course of this year. We will drive good value for our customers and good shareholder returns by building the NCA capability that we've got in cloud native and has been the subject of, you know, a number of questions earlier on on the call. I hope that helps.

**Michael Briest:** All right, thank you very much. Yeah.

**Jonathan Howell:** Thank you.

**Operator:** That's all the time we have for questions. I will now hand the call over to Mr Howell for closing remarks.

**Jonathan Howell:** Thank you very much everybody for those questions. We, clearly – James and myself will be available for, you know, any further questions or discussions that you'd like to have over the next few days. Thank you very much indeed for your time, it's appreciated.

**Operator:** That does conclude the conference for today. Thank you for participating. You may all disconnect.

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