Software AG

Price EUR30.14

Feedback from Capital Markets Day: performance indicators speak for themselves

Fair Value EUR34 (+13%) **BUY**

Bloomberg	SOW GR
Reuters	SOWG.DE
12-month High / Low (EUR)	31.8 / 23.8
Market Cap (EUR)	2,381
Ev (BG Estimates) (EUR)	2,254
Avg. 6m daily volume (000)	232.4
3y EPS CAGR	3.4%

	1 M	3 M	6 M	31/12/15
Absolute perf.	18.6%	13.8%	8.2%	14.1%
Softw.& Comp.	-5.8%	-7.6%	-4.5%	-10.2%
DJ Stoxx 600	-7.7%	-16.2%	-21.2%	-13.8%

YEnd Dec. (€m)	2015	2016e	2017e	2018e
Sales	873.1	877.0	908.9	951.2
% change		*0.5%*	*3.6%*	*4.7%*
EBITDA	278	285	302	321
EBIT	209.4	230.9	248.0	267.2
% change		*10.3%*	*7.4%*	*7.7%*
Net income	187.0	189.9	203.2	217.3
% change		*1.6%*	*7.0%*	*6.9%*

	2015	2016e	2017e	2018e
Operating margin	30.2	30.8	31.6	32.2
Net margin	16.0	17.2	18.1	18.8
ROE	12.8	12.6	12.5	12.0
ROCE	17.7	18.1	19.8	21.7
Gearing	1.3	-10.6	-21.0	-32.6

(€)	2015	2016e	2017e	2018e
EPS	2.32	2.24	2.39	2.56
% change	-	*-3.4%*	*7.0%*	*6.9%*
P/E	13.0x	13.5x	12.6x	11.8x
FCF yield (%)	7.2%	7.5%	8.0%	8.6%
Dividends (€)	0.55	0.60	0.65	0.70
Div yield (%)	1.8%	2.0%	2.2%	2.3%
EV/Sales	2.7x	2.6x	2.3x	2.0x
EV/EBITDA	8.6x	7.9x	7.0x	5.9x
EV/EBIT	9.1x	8.3x	7.3x	6.2x

We reiterate our Buy rating and our DCF-derived Fair Value of EUR34, while we shaved our adj. EPS ests. by 2% (new fx assumptions). Yesterday Software AG held a Capital Markets Day in Darmstadt. The messages from the event were positive: 1) The arrival of Eric Duffaut as Chief Customer Officer 15 months ago was the right decision, 2) Indirect sales are ramping up, 3) Maintenance and R&D/S&M productivity will be key for a 32-35% margin by 2020, 4) Acquisitions are on the agenda.

ANALYSIS

- **The Duffaut effect**. The new sales strategy has been rolled out over 13 months, and its benefits are beginning to show (DBP licence sales: -20% lfl in H1 2015; +8% lfl in H2). This includes selling solutions based on use cases rather than products, in order to increase the win rate and the average deal size. Performance indicators speak for themselves: sales pipeline +18%, strategic accounts on DBP licence sales +43%, DBP deals above EUR1m +53%, average deal size +14%, industry use case-related DBP licence sales +31%. DBP sales productivity +19% (expected to be up double-digit in 2016), DBP headcount -11%. This has been achieved though downsizing, priority to the top of the pyramid to capture big deals (130 strategic accounts), and a focus on premium maintenance. Software AG now boasts a win rate of 1:1 by selling use cases instead of 1:3 by selling products, although there is a lot to be done as use cases only account for 20% of deals.
- **Indirect sales ramping up**. Indirect sales are still emerging, but in 2015 they increased by 3ppt as a percentage of sales (in the low teens), while the number of partners was up 60% and 600+ external new consultants have been trained on Software AG's solutions. Around 20 partners, including Capgemini, Accenture, Wipro and Sopra Steria, work with Software AG on augmenting capacity, bringing industry expertise on the deals, building industry solutions, adding more bandwidth with customers, and reselling the solutions on previously uncovered territories or verticals. However, partners are still essentially acting on a regional or local basis, not globally yet.
- **Precisions on medium-term ambitions**. 1) Most of the non-IFRS operating margin increase to 32-35% for 2020 is expected to stem from DBP maintenance: it still increases by 4% if licence sales remain flat, and is flat if licence sales fall 20%; 2) R&D costs will continue to increase at a lower rate than R&D headcount as more and more work will be sent to low-cost countries (India and Bulgaria: already 52% of headcount) with no compromise on quality, and management plans to cut R&D costs for Adabas & Natural (A&N) by 25-30% without decreasing the R&D headcount, 3) In the medium-term, A&N could still have a margin in the high 60s.
- **Update on cloud**. Demand is oriented towards hybrid cloud integration, but Software AG will continue to sell primarily on a licence+maintenance mode, on-premise and, when required, deployment on private clouds. Although the pipeline surged by 131% (sales +75%) in 2015, public cloud will stay only on a limited number of highly standardised products (ARIS and Alfabet).
- **Update on acquisitions**. Over the past two years, Software AG made no acquisitions as prices were too high. However management estimates there are signs that prices are coming down (some companies struggle to leverage their buyouts, stock markets down) for unlisted companies. Software AG is prepared and is working with banks to increase financial flexibility to buy in cash, not in shares. If no acquisition occurs, share buy-backs (3.5% now, potential: 10%) will resume.

VALUATION

- Software AG's shares are trading at est. 8.3x 2016 and 7.3x 2017 EV/EBIT multiples.
- Net debt on 31st December 2015 was EUR13.9m (net gearing: 1%).

NEXT CATALYSTS

Q1 2016 results on 26th April before markets open.

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