BRYAN, GARNIER & CO

FOCUS
TMT CONFERENCE

22nd March 2016

TMT

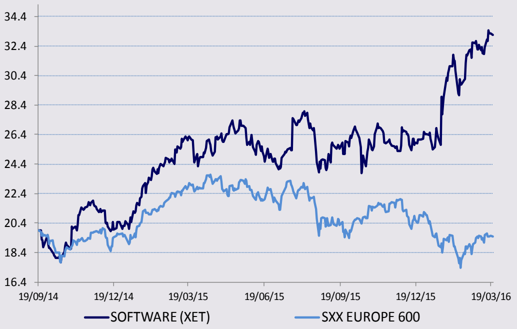
Software AG

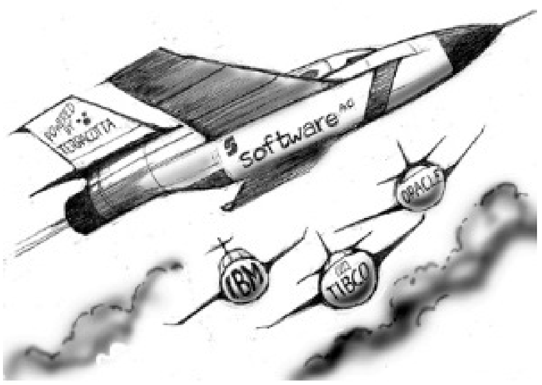
From value to growth

Fair Value EUR38 vs. EUR34 (price EUR33.14) **BUY**

Bloomberg	SOW GR
Reuters	SOWG.DE
12-month High / Low (EUR)	33.5 / 23.8
Market capitalisation (EURm)	2,618
Enterprise Value (BG estimates EURm)	2,490
Avg. 6m daily volume ('000 shares)	254.5
Free Float	64.9%
3y EPS CAGR	3.7%
Gearing (12/15)	1%
Dividend yield (12/16e)	1.81%

YE December	12/15	12/16e	12/17e	12/18e
Revenue (€m)	873.06	881.59	913.89	956.35
EBITA €m)	263.4	272.2	289.8	309.2
Op.Margin (%)	30.2	30.9	31.7	32.3
Diluted EPS (€)	2.32	2.25	2.41	2.58
EV/Sales	3.0x	2.8x	2.6x	2.2x
EV/EBITDA	9.5x	8.7x	7.7x	6.6x
EV/EBITA	10.0x	9.1x	8.1x	6.9x
P/E	14.3x	14.7x	13.7x	12.8x
ROCE	17.7	18.3	19.9	21.9





We raise our DCF-derived fair value to EUR38 from EUR34 on an increase to our medium-term adj. EBIT margin assumption (to 35% from 33% = +EUR2/share) and an update to our WCR ests. (+EUR2). The meetings held at our TMT conference confirmed that the sales transformation led by Eric Duffaut has started to bear fruit, gradually raising Software AG's stock market status to "growth" from "value".

- **Digital Business Platform (DBP) starting the upturn.** Q4 15 has been the first quarter with double-digit lfl DBP licence sales growth since 2013. Software AG reaps the benefits of the sales transformation it underwent a year ago under the management of Eric Duffaut. All the performance indicators speak for themselves. 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.

- **Adabas & Natural still to be there for long.** The resilience of A&N revenues is no longer surprising as Software AG focuses a lot on customer retention. Customers in the installed base are not left behind. Management is confident A&N will deliver for 2016 a business line margin close to the 70% reported for 2015.

- **Reiterated confidence in 2020 targets.** FY16 company guidance (DBP sales up 5-10%, A&N sales down 4-8%, non-IFRS operating margin of 30-31%) brings more confidence to be on track for achieving the 32-35% target set a year ago for 2020: 1). Most of the non-IFRS operating margin increase for 2020 is expected to stem from DBP maintenance; 2). R&D costs will continue to increase at a lower rate than R&D headcount; and 3). In the medium-term, A&N could still have a margin in the high 60s.

- **Always prepared for 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 for unlisted companies. Software AG is prepared and is working with banks to increase financial flexibility to buy using cash, not shares. If no acquisition occurs, share buy-backs (3.5% up to now, potential: 10%) will resume.

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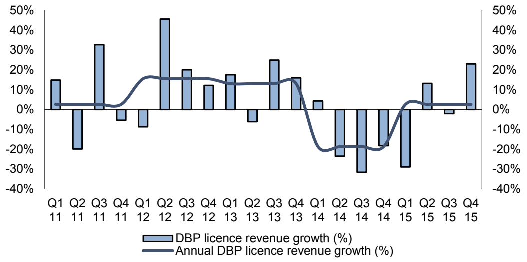
Software AG major keys to focus on from the TMT conference

1. One Chart



- **Digital Business Platform (DBP) starting the upturn**. Q4 15 has been the first quarter with double-digit lfl DBP licence revenue growth (+17%) since 2013. Over the quarter, licence sales were up 18% in the US, well above 100% in the UK, 72% in France, 66% in Nordic countries, 72% in Italy, 62% in Eastern Europe and 22% in the Middle East, while Q4 15 was a poor quarter in Brazil and uncertainties prevailed in Asia Pacific (China and its main trade partners). Software AG is reaping the benefits of the sales transformation it underwent a year ago under the management of Eric Duffaut, with much work on the value proposition and several large digital transformation deals won recently (Bosch, EDF, Wells Fargo, Walgreens Boots Alliance...).

- **Adabas & Natural to be there beyond 2015**. The resilience of A&N revenues (mid-to-high single-digit decline) is no longer surprising as Software AG focuses a lot on customer retention. Customers in the installed base are not left behind: they have been offered premium support and they are accompanied in their digital transformation. Management is confident A&N will deliver for 2016 a business line margin close to the 70% reported for 2015, probably in the high 60s.

- **Consulting transformation achieved**. Consulting has achieved its transformation. It had 40 new customer references in 2015 and it moved away from the project-based model, which augurs well for a sustainable double-digit business line margin in our view.

- **Reiterated confidence in 2020 targets**. FY16 company guidance (DBP product sales up 5-10% at cc, A&N product sales down 4-8% at cc, non-IFRS operating margin of 30-31%) brings more confidence to be on track for achieving the 32-35% target set a year ago for 2020 - provided that an economic shock does not jeopardise it: 1). Most of the non-IFRS operating margin increase for 2020 is expected to stem from DBP maintenance: it still rises 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), and management plans to cut R&D costs for Adabas & Natural (A&N) by 25-30% without decreasing the R&D headcount, and 3). In the medium-term, A&N could still have a margin in the high 60s.

2. One Sentence

« We are always prepared for 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% up to now, potential: 10%) will resume.

3. One Figure

19

19 is the percentage increase in sales productivity for the Digital Business Platform (DBP) since the appointment of Eric Duffaut as Chief Customer Officer 14 months ago. The benefits of the new strategy - selling solutions based on use cases rather than products, in order to increase the win rate and the average deal size - are beginning to show, with DBP licence sales up 8% lfl in H2 15 vs. -20% lfl in H1 2015. **Performance indicators speak for themselves**: sales pipeline up 18%, strategic accounts on DBP licence sales up 43%, DBP deals above EUR1m up 53%, average deal size up 14%, industry use case-related DBP licence sales up 31%. DBP sales productivity up 19% (still expected to be up double-digit in 2016), DBP headcount down 11%. This has been achieved through 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 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% in 2015 and 600+ external new consultants have been trained on Software AG's solutions. At least 20 partners, including Capgemini ("Connected Service Experience"), Accenture, TCS ("Global Operations Solutions"), Infosys ("Smart Work Bench"), Cognizant ("Intraday Liquidity Monitoring"), Wipro ("Wipro Looking Glass"), PwC ("Continuous Assurance"), and Sopra Steria, work with Software AG on 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.

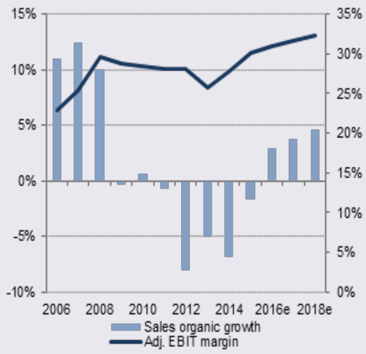
Finally, the demand is oriented towards hybrid cloud integration, but Software AG will continue to sell primarily on a licence plus maintenance mode, on-premise and, when required, deployment on private clouds. Although the pipeline surged by 131% (sales +75%) in 2015, public cloud will stay only on a limited number of highly standardised products (ARIS on business process analysis and Alfabet on IT asset management).

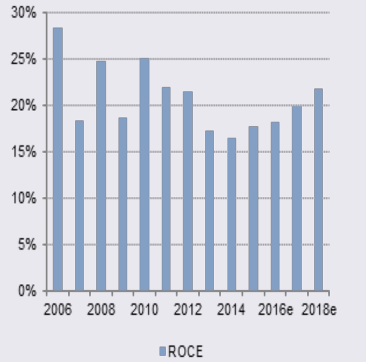
4. How does the Conference impact our Investment Case

We reiterate our Buy rating and raise our DCF-derived fair value to EUR38 from EUR34 on an increase to our medium-term adj. EBIT margin assumption (to 35% from 33% = +EUR2/share) and an update to our WCR assumptions (to 11% of sales from 4% of sales vs. 6% in 2015 = +EUR2/share). **The meetings we had at our TMT conference confirmed that the sales transformation has started to bear fruit**. This is, in our view, gradually transforming the status of the Software AG stock to "growth" from "value". As such, given the fact the company guided for a non-IFRS operating margin of 30-31% for 2016 while cost control is likely to remain strict in the years to come (offshoring R&D, services and support, effort on sales productivity…), **we have increased our level of confidence regarding Software AG's ability to reach the top-end of the 32-35% goal set a year ago for 2020**.

Next Catalysts

26/04/2016 Q1 16 results before markets open - conference call
20/07/2016 Q2 16 results before markets open - conference call





Company description

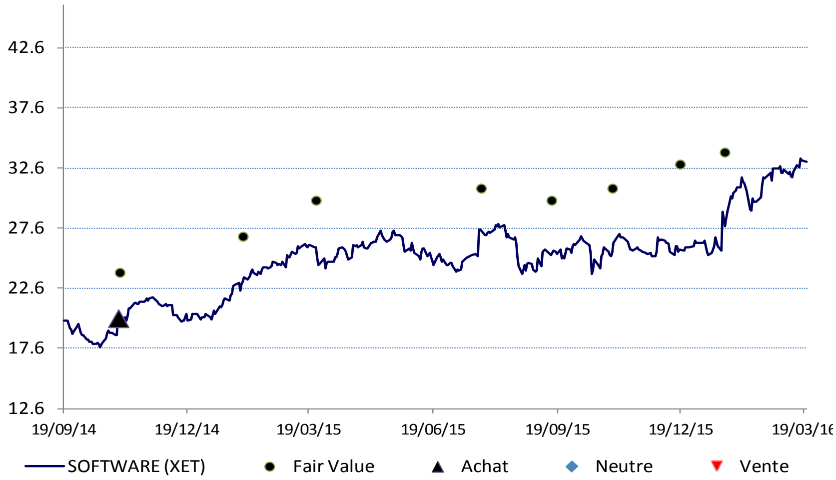
Founded in 1969, and listed on the Frankfurt Stock Exchange since 1999, Software AG markets enterprise software addressing two specific needs: 1). Helping businesses to digitise their processes, through its Digital Business Platform (64% of Product revenues: business and IT transformation, streaming analytics, agile apps, IT portfolio management, integration and connectivity); 2). Modernisation of legacy IT systems through Adabas & Natural (36% of Product revenue: database management systems and application development), providing mission-critical mainframe applications with technologies enhancing performance. The company generates 45% of Product revenues in America, vs. 48% in the EMEA region (incl. 14% in Germany) and 7% in Asia Pacific. By Industry, 20% of Product revenues are made with Governments, vs. 19% in Financial Services, 19% in IT Services, 12% in Business Services, 10% in Manufacturing, and 20% with other industries (Telecoms/Media, Transport/Logistics, etc.).

Simplified Profit & Loss Account (EURm)	**2013**	**2014**	**2015**	**2016e**	**2017e**	**2018e**
Revenues	973	858	873	882	914	956
Change (%)	*-7.1%*	*-11.8%*	*1.8%*	*1.0%*	*3.7%*	*4.6%*
Ifl change (%)	*-5.0%*	*-6.8%*	*-1.7%*	*2.9%*	*3.7%*	*4.6%*
Adjusted EBITDA	264	250	278	287	305	324
Depreciation & amortisation	(12.9)	(11.6)	(14.4)	(14.5)	(14.8)	(15.0)
Adjusted EBIT	251	238	263	272	290	309
EBIT	206	176	209	233	251	270
Change (%)	*-17.2%*	*-14.4%*	*19.0%*	*11.3%*	*7.5%*	*7.7%*
Financial results	(8.4)	(9.2)	(2.9)	(5.0)	(2.2)	(0.26)
Pre-Tax profits	197	167	207	228	249	270
Exceptionals	0.0	0.0	0.0	0.0	0.0	0.0
Tax	(63.1)	(56.3)	(66.9)	(75.3)	(82.0)	(89.1)
Profits from associates	0.0	0.0	0.0	0.0	0.0	0.0
Minority interests	0.18	0.19	0.16	0.15	0.20	0.25
Net profit	134	110	139	153	166	181
Restated net profit	178	164	187	191	205	219
Change (%)	*-14.6%*	*-7.7%*	*13.7%*	*2.4%*	*7.1%*	*6.9%*
Cash Flow Statement (EURm)						
Operating cash flows	193	147	180	202	216	231
Change in working capital	(21.0)	(3.5)	5.3	1.9	1.3	0.99
Capex, net	(12.7)	(8.0)	(9.8)	(10.5)	(10.5)	(10.5)
Financial investments, net	(56.6)	(1.3)	43.5	0.0	0.0	0.0
Acquisitions, net	(106)	14.4	(1.5)	0.0	0.0	0.0
Dividends	(38.3)	(36.4)	(39.6)	(43.5)	(47.4)	(51.4)
Other	330	(174)	(127)	(23.2)	(23.2)	28.2
Net debt	107	70.4	13.9	(128)	(279)	(492)
Free Cash flow	159	135	176	193	207	221
Balance Sheet (EURm)						
Tangible fixed assets	64.5	61.2	56.2	52.2	47.9	43.4
Intangibles assets & goodwill	1,041	1,037	1,057	1,033	1,008	984
Investments	4.5	7.1	24.5	24.5	24.5	24.5
Deferred tax assets	16.3	10.9	11.0	11.0	11.0	11.0
Current assets	364	359	353	354	363	377
Cash & equivalents	506	374	312	439	575	773
Total assets	1,997	1,849	1,815	1,913	2,031	2,213
Shareholders' equity	966	1,013	1,090	1,199	1,318	1,499
Provisions	142	135	81.9	83.9	85.9	87.9
Deferred tax liabilities	22.6	17.1	16.7	16.7	16.7	16.7
L & ST Debt	613	444	326	311	296	281
Current liabilities	254	240	300	302	314	328
Total Liabilities	1,997	1,849	1,815	1,913	2,031	2,213
Capital employed	1,072	1,084	1,104	1,071	1,039	1,007
Ratios						
Operating margin	25.80	27.75	30.18	30.88	31.71	32.33
Tax rate	32.01	33.73	32.40	33.00	33.00	33.00
Net margin	13.76	12.86	15.97	17.32	18.20	18.88
ROE (after tax)	13.86	10.89	12.80	12.74	12.62	12.04
ROCE (after tax)	17.31	16.56	17.74	18.26	19.94	21.86
Gearing	11.07	6.95	1.27	(10.67)	(21.18)	(32.82)
Pay out ratio	29.88	39.39	31.16	31.03	30.87	30.63
Number of shares, diluted	88.74	88.66	80.72	84.90	84.90	84.90
Data per Share (EUR)						
EPS	1.54	1.27	1.77	1.93	2.11	2.29
Restated EPS	2.01	1.86	2.32	2.25	2.41	2.58
% change	*-14.5%*	*-7.6%*	*24.9%*	*-2.7%*	*7.1%*	*6.9%*
EPS bef. GDW	2.01	1.86	2.32	2.25	2.41	2.58
BVPS	10.88	11.43	13.50	14.12	15.53	17.66
Operating cash flows	2.17	1.65	2.23	2.38	2.54	2.71
FCF	1.79	1.52	2.18	2.28	2.44	2.60
Net dividend	0.46	0.50	0.55	0.60	0.65	0.70

Source: Company Data; Bryan, Garnier & Co ests.

Price Chart and Rating History

Software AG



Ratings

Date	Ratings	Price
29/10/14	BUY	EUR18.69
16/07/14	NEUTRAL	EUR20
19/07/13	BUY	EUR25.82

Target Price

Date	Target price
20/01/16	EUR34
18/12/15	EUR33
29/10/15	EUR31
14/09/15	EUR30
24/07/15	EUR31
24/03/15	EUR30
29/01/15	EUR27
30/10/14	EUR24
16/07/14	EUR23
15/07/14	Under review
10/01/14	EUR34
25/10/13	EUR32
26/07/13	EUR30
19/07/13	EUR32
26/04/13	EUR28

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Bryan Garnier stock rating system

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Stock rating

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SELL — Negative opinion for a stock where we expect an unfavourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential downside based on valuation), but also takes into account a number of elements that could include a SWOT analysis, momentum, technical aspects or the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

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