

## Sage Group

Price 582.00p

## H1 FY16 analysts' meeting feedback: executing broadly on plan

Fair Value 555p vs. 550p (-5%)

SELL

Bloomberg	SGE L
Reuters	SGE.LN
12-month High / Low (p)	636.5 / 489.7
Market Cap (GBP)	6,282
Ev (BG Estimates) (GBP)	6,426
Avg. 6m daily volume (000)	2,842
3y EPS CAGR	9.4%

We reiterate our Sell rating, but raise our DCF-derived fair value to 555p from 550p as we up our adj. EPS ests. by 1%. Growth momentum is there, and cost savings should allow Sage to exceed an op. margin of 28.5% in H2 FY16. However, such a 2ppt margin increase is not extrapolable to FY17 as part of the GBP50m cost savings will be reinvested in marketing. Despite yesterday's share price decline, Sage's demanding valuation multiples create no positive catalyst for the stock, in our view.

## ANALYSIS

	1 M	3 M	6 M	31/12/15
Absolute perf.	-6.7%	-3.2%	6.8%	-3.6%
Softw. & Comp.	-0.9%	2.1%	-4.6%	-6.1%
DJ Stoxx 600	1.4%	2.1%	-12.1%	-9.0%

YEnd Sept. (£m)	09/15	09/16e	09/17e	09/18e
Sales	1,436	1,548	1,672	1,793
% change		7.8%	8.1%	7.2%
EBITDA	418	453	495	539
EBIT	389.0	429.8	471.5	515.3
% change		10.5%	9.7%	9.3%
Net income	283.9	302.3	337.6	371.7
% change		6.5%	11.7%	10.1%

	09/15	09/16e	09/17e	09/18e
Operating margin	27.1	27.8	28.2	28.7
Net margin	13.5	13.6	18.7	19.4
ROE	22.5	23.0	29.7	28.5
ROCE	25.2	33.0	35.2	40.8
Gearing	39.6	15.8	-5.4	-22.8

(p)	09/15	09/16e	09/17e	09/18e
EPS	25.29	26.92	30.06	33.09
% change	-	6.5%	11.7%	10.1%
P/E	23.0x	21.6x	19.4x	17.6x
FCF yield (%)	4.5%	5.1%	5.7%	6.2%
Dividends (p)	13.10	14.15	15.28	16.50
Div yield (%)	2.3%	2.4%	2.6%	2.8%
EV/Sales	4.6x	4.2x	3.7x	3.3x
EV/EBITDA	15.8x	14.2x	12.6x	11.1x
EV/EBIT	17.0x	15.0x	13.2x	11.7x

- Cost savings should ensure an operating margin above 28.5% in H2 FY16.** Despite the underlying operating margin down 1ppt to 25.4%, management is confident to deliver at least 27% for FY16 vs. 27.5% for FY15. This implies a margin above 28.5% for H2 FY16, up 2ppt vs. H2 FY15 and up 3.2ppt vs. H1 FY16 - which is unusual in terms of profit seasonality. The GBP17m cost saving secured in H1 (GBP12m on payroll and GBP5m on facilities) is in line with the GBP50m expected for FY16 on an annual basis, which means GBP33m is planned for H2 (procurement, G&A costs), but Sage will spend more on sales and marketing with less people. However, the margin increase expected for H2 FY16 cannot be extrapolated to FY17 as part of the savings will be reinvested in digital marketing. Of the GBP100m restructuring costs to be booked in FY16 (GBP31.2m in H1 o/w GBP22m in G&A and GBP9m in sales and marketing), cash-outs related to restructurings were GBP12m in H1 and GBP50m is expected for FY16, while GBP50m is still to be cashed out during FY17. NB: 70% of the top 100 managers at Sage has been replaced in one year.
- Revenue momentum, driven by subscriptions, remains positive.** The 35.3% lfl subscription revenue growth in H1 FY16 is at the high-end of what is sustainable on the installed base. Two-thirds of the acceleration, which allowed Sage to reach an annual subscription base of GBP425m, is driven by migration from perpetual licenses (Sage 50 in North America + Europe, Payroll in North America, South Africa products, Sage 100 in France, Payroll in Australia...), upselling and cross-selling. To be more sustainable, the 35% increase in subscriptions needs more customer additions or reactivations. On Processing, the growth rate reported for H1 (+6.6%) marks some progress, but was driven by Payroll processing in the US (PayChoice), while Payments in the US is back to growth (+2%) with 7 new ISVs partners, but requires acceleration in cross-selling before growing double-digit. Sage One is progressing steadily, with recent country launches being pretty successful (Brazil 10,000 subscriptions reached in 8 months, Australia 1,000), while the US is progressing strongly but remains small. On Sage X3, the turnaround is there with sales up 17%, including France at +20%, the UK at +25% and International at +60%, while North America is flat.
- Partnerships and acquisitions.** The partnership with Fairsail - Sage will buy a 20.7% stake in the company - adds cloud-based Human Capital Management HCM solutions to accounting and payroll on Sage X3. Sage remains committed to acquisition policy, and, as such, sees opportunities essentially on 'bolt-on' deals. Increasing the geographic footprint looks more complex except by using internal digital marketing, as most of the local leaders are owned by private equity firms.

## VALUATION

- Sage's shares are trading at est. 15.0x FY16 and 13.2x FY17 EV/EBIT multiples.
- Net debt on 31<sup>st</sup> March 2016 was GBP270.9m (net gearing: 30%).

## NEXT CATALYSTS

Q3 FY16 trading update on 27<sup>th</sup> July before markets open.

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