

Software AG

Price EUR33.80

Q3 2016 conference call feedback: just a matter of days

Fair Value EUR40 (+18%)

BUY

| | |
|----------------------------|-------------|
| Bloomberg | SOW GR |
| Reuters | SOWG.DE |
| 12-month High / Low (EUR) | 38.9 / 24.2 |
| Market Cap (EURm) | 2,670 |
| Ev (BG Estimates) (EURm) | 2,543 |
| Avg. 6m daily volume (000) | 190.6 |
| 3y EPS CAGR | 5.3% |

We reiterate our Buy recommendation after the 9% share price fall following the slippage in strategic deals from late September to early October: 1) Software AG remains on the right trajectory to deliver FY16 guidance, probably at the top-end for non-IFRS operating margin; 2) the signing of a rising number of large strategic deals shows that the Digital Business Platform (DBP) is increasingly on the Boards of Directors' agenda; 3) execution is constantly improving in sales and Consulting.

ANALYSIS

- Ammunition for reaching FY16 guidance.** Despite the sales shortfall in Q3 2016, management is confident it can reach FY16 guidance: at the low-to-mid point of the +5-10% cc range for DBP revenues, at the mid-to-high point of the -6/-2% cc range for A&N (Adabas & Natural) revenues, and at the mid-to-high point of the 30.5-31.5% range for non-IFRS operating margin (BG est.: 31.6%) while it was up 2.8ppt year-to-date vs. a full-year target of +0.8ppt/+1.8ppt. The DBP licence pipeline for Q4 2016 is growing, with the number of deals of EUR1m+ up 77% (+56% in value). In A&N, seasonality was disturbed as one large deal in South Africa (EUR3m) was signed in Q1 instead of Q3, but Q4 is expected to return to a normal seasonal pattern. Finally, in Consulting, management considers the shift to strategic profitable services related to topics like IoT from product-related low-margin projects will continue to translate into higher margins in the future. As such, the 16.9% Consulting margin reported for Q3 2016 was not a one-time peak.
- Strategic deals: one week can make all the difference in a given quarter.** The revenue shortfall in Q3 2016 stemmed from the slippage in early October of three deals for a total value of EUR7.3m, related to the Internet of Things (IoT) and Industry 4.0. Management mentioned that these deals (which were signed at the Board level including the CEO, and thus implied a complex and lengthy decision process) took several quarters and were too important to be exposed to procurement tactics just before the quarter closed. One of these strategic deals was signed with Bosch, which will use Software AG's DBP to build the foundation of its own IoT platform (Bosch IoT Cloud). The other was with the Italian company Octo Telematics, which will use Software AG's device management technology on top of its IoT foundation platform for a connected car use case. Three additional strategic partnerships with customers are to be announced in coming months.
- Further DBP metrics.** On a pro forma basis including the business until 11/10/2016, DBP licence sales in Q3 2016 were up 26% in the US with an 8-digit licence and maintenance deal with 3M, Asia Pacific was up 93% driven by Australia, Latin America was up 96% driven by noticeable deals in Brazil and Mexico, and in EMEA France and Nordic countries were up 54% and 42%, respectively. Including Bosch signed early Q4, Germany would be up 36%. Finally, the conversion rate for deals above EUR1m is 36% (28% for deals below EUR1m).
- Pursuing sales efficiency.** The 20% decline in sales and marketing costs in Q3 2016 was related to the reorganisation of sales operations in Q4 2015 and Q1 2016, usual seasonality (the vacation period), the fall in sales commissions (which will actually be paid in Q4), and the release of bad debt provisions in Brazil as customers start to pay their bills again, by instalments. NB. No noticeable impact from Brexit has been seen, even with banks in the UK.

| | 1 M | 3 M | 6 M | 31/12/15 |
|----------------|-------|------|-------|----------|
| Absolute perf. | -6.8% | 1.3% | 0.9% | 27.9% |
| Softw. & Comp. | -0.7% | 8.9% | 9.0% | 5.5% |
| DJ Stoxx 600 | 0.5% | 0.4% | -1.2% | -7.1% |

| YEnd Dec. (€m) | 2015 | 2016e | 2017e | 2018e |
|----------------|-------|-------|-------|-------|
| Sales | 873.1 | 881.7 | 912.8 | 955.3 |
| % change | | 1.0% | 3.5% | 4.7% |
| EBITDA | 278 | 295 | 307 | 329 |
| EBIT | 209.4 | 234.9 | 256.7 | 278.9 |
| % change | | 12.1% | 9.3% | 8.6% |
| Net income | 188.0 | 195.4 | 203.6 | 219.7 |
| % change | | 3.9% | 4.2% | 7.9% |

| | 2015 | 2016e | 2017e | 2018e |
|------------------|------|-------|-------|-------|
| Operating margin | 30.2 | 31.8 | 32.0 | 32.9 |
| Net margin | 16.0 | 17.6 | 18.8 | 19.7 |
| ROE | 12.8 | 12.9 | 12.9 | 12.8 |
| ROCE | 17.7 | 19.0 | 20.0 | 22.1 |
| Gearing | 1.3 | -10.6 | -21.2 | -30.8 |

| (€) | 2015 | 2016e | 2017e | 2018e |
|---------------|-------|-------|-------|-------|
| EPS | 2.33 | 2.42 | 2.52 | 2.72 |
| % change | - | 3.9% | 4.2% | 7.9% |
| P/E | 14.5x | 14.0x | 13.4x | 12.4x |
| FCF yield (%) | 6.4% | 7.3% | 7.7% | 8.5% |
| Dividends (€) | 0.55 | 0.60 | 0.65 | 0.70 |
| Div yield (%) | 1.6% | 1.8% | 1.9% | 2.1% |
| EV/Sales | 3.1x | 2.9x | 2.6x | 2.3x |
| EV/EBITDA | 9.7x | 8.6x | 7.8x | 6.7x |
| EV/EBIT | 10.2x | 9.1x | 8.2x | 7.1x |



VALUATION

- Software AG's shares are trading at est. 9.1x 2016 and 8.2x 2017 EV/EBIT multiples.
- Net cash position on 30th June 2016 was EUR65.8m (net gearing: -6%).

NEXT CATALYSTS

Final Q3 2016 results on 20th October before markets open.

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| | |
|---------|---|
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