24th November 2016

TMT

Software AG

Price EUR33.55

Reiterating our Buy case: a look at what could be 2017

Fair Value EUR40 (+19%) **BUY**

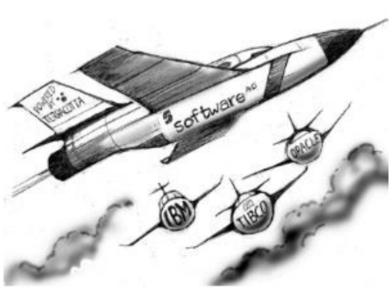
Bloomberg	SOW GR
Reuters	SOWG.DE
12-month High / Low (EUR)	38.9 / 25.3
Market Cap (EUR)	2,650
Ev (BG Estimates) (EUR)	2,541
Avg. 6m daily volume (000)	202.7
3y EPS CAGR	5.0%

	1 M	3 M	6 M	31/12/15
Absolute perf.	-0.8%	-6.7%	-2.5%	27.0%
Softw.& Comp.	-4.5%	-1.3%	6.7%	2.9%
DJ Stoxx 600	-1.0%	-0.8%	1.2%	-6.8%

YEnd Dec. (€m)	2015	2016e	2017e	2018e
Sales	873.1	874.0	918.9	957.2
% change		*0.1%*	*5.1%*	*4.2%*
EBITDA	278	283	301	321
EBIT	209.4	223.0	249.2	273.8
% change		*6.5%*	*11.7%*	*9.9%*
Net income	188.0	190.9	203.6	217.4
% change		*1.5%*	*6.7%*	*6.8%*

	2015	2016e	2017e	2018e
Operating margin	30.2	31.1	31.6	32.4
Net margin	16.0	16.9	18.1	19.3
ROE	12.8	12.4	12.7	12.7
ROCE	17.7	18.4	19.9	21.7
Gearing	1.3	-9.2	-19.9	-29.4

(€)	2015	2016e	2017e	2018e
EPS	2.33	2.37	2.52	2.69
% change	-	*1.5%*	*6.7%*	*6.8%*
P/E	14.4x	14.2x	13.3x	12.5x
FCF yield (%)	6.5%	7.1%	7.6%	8.3%
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	9.6x	9.0x	7.9x	6.9x
EV/EBIT	10.1x	9.3x	8.2x	7.2x



We reiterate our Buy recommendation and our DCF-derived Fair Value of EUR40. We have shaved our adj. EPS ests. by 2% for 2016 and 1% for 2017-18, with slightly more cautious assumptions on opex, offset by fx tailwinds for 2017 (+1.9ppt). While the acceleration in growth looks to be the "icing on the cake", we consider reaching the top-end of non-IFRS op. margin guidance is enough to drive the share price upwards, while the transformation of the sales model is well engaged in our view.

ANALYSIS

- **Back to the margin guidance corridor for 2016**. Whereas after Q3 results we believed in Software AG's ability to exceed its FY16 non-IFRS operating margin guidance range of 30.5-31.5% (vs. 29.7% in 2015), we now expect the FY16 margin to come out at 31.4% (implying Q4 -2.3ppt to 33.5%) vs. 32.1%, with 2.2% lfl sales growth vs. +2.7%: 1) on DBP (Digital Business Platform), we now expect sales up 5% lfl to EUR445.3m (o/w +8% lfl for Q4 with +13% lfl on licence sales) vs. EUR449.1m and a margin up 4.5ppt to 33.5% (o/w -3.2ppt to 41% for Q4) vs. 34.3%, with large IoT deals delayed to October from September (Bosch, Octo Telematics…) partly offset by high comps (Q4 2015 was up 11% lfl, o/w +17% lfl on licences); 2) on A&N (Adabas & Natural), we are comfortable with a 4% lfl sales dip to EUR233.9m (o/w +2% lfl for Q4) and a margin down 1.6ppt to 68.4% (o/w -0.7ppt to 64.2% for Q4); 3) in Consulting, sales will be dented by the downsizing of services related to third-party products (o/w Spain) and fx headwinds in the UK, so we now forecast sales up 3% lfl to EUR194.8m (o/w -5% lfl for Q4) vs. EUR198.3m and now estimate the margin to be down 1.5ppt to 9.8% (with Q4 down 4.4ppt to 9.4%) vs. 11.1%; 4) G&A costs are likely to rise sharply in Q4 (BG est.: +20%) due to a catch-up in salary increases.
- **We bank on a 31.5-32% non-IFRS operating margin for 2017**. For 2017, we adopt a more cautious stance on the non-IFRS operating margin (31.9% vs. 32.4%) and consider Software AG may guide for DBP sales up 5-10% lfl, A&N sales down 2-6% lfl, and a non-IFRS operating margin range of 31.5-32%. Our lfl sales growth scenario remains virtually unchanged, at +3.2% vs. +3.3%, but we estimate fx tailwinds at +1.9ppt on sales (vs. +0.2ppt previously). We consider a lfl sales growth acceleration could be enabled by a mix effect, with DBP (est. 53% of sales for 2017, vs. an est. 51% for 2016) leading the growth. On DBP (BG est.: sales +8% lfl, margin +3.1ppt to 36.6%), while 2016 is likely to reach the bottom-end of the 5-10% growth range, we consider sales productivity gains and a higher average deal size will allow for 8% lfl growth in 2017. In A&N (BG est.: sales -5% lfl, margin -0.6ppt to 67.8%), a trend change is unlikely as the commitment to support A&N products beyond 2050 will not prevent licence sales from falling over time. In Consulting (BG est.: sales +2% lfl, margin +1.8ppt to 11.6%), we still expect modest lfl growth as the shift to strategic services related to topics like IoT from product-related projects will be achieved.
- **No reason to reconsider the 32-35% margin scenario for 2020**. In early 2015, management announced its aim to deliver a 32-35% non-IFRS op. margin scenario for 2020. While we doubt the bottom-end of this range will be achieved in 2016 or even in 2017, we are comfortable it will be reached in 2018. Our sequence of progression is: +1.7ppt to 31.4% for 2016, +0.5ppt to 31.9% for 2017, +0.8ppt to 32.7% for 2018, +0.8ppt to 33.5% for 2019, and +0.9ppt to 34.4% for 2020. This will be, in our view, driven by sales of business digital solutions with a higher average deal size, the expansion of the ecosystem of partners, and extended sales coverage.

VALUATION

- Software AG's shares are trading at est. 9.3x 2016 and 8.2x 2017 EV/EBIT multiples.
- Net cash position on 30th September 2016 was EUR93.4m (net gearing: -8%).

NEXT CATALYSTS

FY16 results on 26th January 2017 before markets open.

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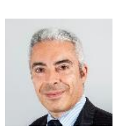

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