1st December 2016

TMT

Sage Group

Price 657.50p

FY16 results analysts' meeting feedback: keeping the direction, but paying the price for it

Fair Value 645p vs. 690p (-2%) **NEUTRAL vs. SELL**

Bloomberg	SGE L
Reuters	SGE.LN
12-month High / Low (p)	756.0 / 544.5
Market Cap (GBPm)	7,101
Ev (BG Estimates) (GBPm)	7,223
Avg. 6m daily volume (000)	2 638
3y EPS CAGR	13.0%

	1 M	3 M	6 M	31/12/15
Absolute perf.	-8.9%	-9.3%	7.3%	8.9%
Softw.& Comp.	-0.9%	-2.6%	2.8%	2.6%
DJ Stoxx 600	0.9%	-0.4%	-1.6%	-6.5%

YEnd Sept. (£m)	09/16	09/17e	09/18e	09/19e
Sales	1,569	1,847	1,978	2,136
% change		*17.7%*	*7.1%*	*8.0%*
EBITDA	468	552	601	661
EBIT	300.4	393.5	541.5	600.6
% change		*31.0%*	*37.6%*	*10.9%*
Net income	313.6	380.8	419.7	457.6
% change		*21.4%*	*10.2%*	*9.0%*

	09/16	09/17e	09/18e	09/19e
Operating margin	27.9	28.2	28.8	29.4
Net margin	13.2	15.2	19.8	20.1
ROE	19.7	26.5	31.8	29.4
ROCE	26.9	35.6	37.3	42.5
Gearing	29.7	11.4	-6.7	-25.0

(p)	09/16	09/17e	09/18e	09/19e
EPS	27.84	33.63	36.89	40.21
% change	-	*20.8%*	*9.7%*	*9.0%*
P/E	23.6x	19.5x	17.8x	16.4x
FCF yield (%)	3.4%	4.5%	5.2%	6.4%
Dividends (p)	14.15	15.28	16.50	17.82
Div yield (%)	2.2%	2.3%	2.5%	2.7%
EV/Sales	4.7x	3.9x	3.5x	3.2x
EV/EBITDA	15.8x	13.1x	11.7x	10.2x
EV/EBIT	16.9x	13.9x	12.3x	10.7x

We have upgraded our rating to Neutral from Sell and cut our DCF-derived Fair Value to 645p from 690p as we have shaved our EPS ests. by 1% for FY17-18 and 2% for FY19 on updated fx (-10p/share), higher net debt due to restructuring cash-outs (-25p) and new WCR assumptions (-10p). The shares are now trading at more reasonable levels and Sage is maintaining the course of its transformation plan, but we do not expect a lfl growth acceleration for FY17 due to the fall in perpetual licence sales. In addition, such a transformation will require further exceptional costs this year, up to GBP100m.

ANALYSIS

- **No acceleration due to the fall in perpetual licence revenues**. Revenue growth in FY16 (+6.1% lfl) was led by subscriptions (+32.3% lfl), but SSRS revenues (-8.5% lfl, o/w -15% lfl on perpetual licences) are dragged down by the switch to subscriptions. Subscription revenues were up 28% in Europe (o/w +39% in the UK, +14% in France, +52% in Spain and +48% in Germany), up 84% (from a low base) in North America, and up 32% in Africa. Sage One subscription revenue growth (+54%) was 41% in Europe (o/w +66% in the UK), 86% in North America, and took off in the International region (+71% in Africa). That said, Sage's GBP130m annualised subscription base surge was driven by other brands like Sage 50 Accounting (35% of the surge) and Payroll (12%), Sage 200 (23%) and Accountants Suite (13%). Sage X3, dedicated to multinational mid-market businesses, saw revenues up 18%, o/w +12% in Europe (+17% in the UK), +7% in North America (+18% in H2), and +74% in the International region (+77% in Africa), and remains led by perpetual licences.

- **Trying to solve inefficiencies**. The focus is now on: 1) new customer acquisitions in Europe and North America as most of the growth in subscriptions comes from the installed base; 2) new product launches; 3) the US Payments business, as progress in marketing and the partner channel is slow; 4) growth in Asia; 5) the low contract renewal rate in the International region (78% vs. 89% in Europe and North America) due to high bankruptcy rates, which needs more subscriptions.

- **Entering phase 2 of transformation**. The 0.7ppt op. margin increase to 27.2% in FY16 was achieved thanks to G&A cost savings (+2.2ppt) and other items (+0.9ppt) and despite reinvestment in marketing (-1.2ppt) and sales (-1.2ppt). The GBP51m in annualised savings generated in FY16 (o/w GBP35m delivered in the year) allowed for a 3ppt cut in the G&A costs ratio, while marketing costs have been reallocated towards digital marketing at the expense of staff. The next stage of transformation will be keeping the G&A cost ratio down and raising sales and marketing productivity, which implies changes in the skills required. The appointment in August 2016 of Blair Crump (ex-leader of Salesforce's Global Enterprise business and ex-President Worldwide Sales & Consulting at Verizon) as President of Sales & Customer Services, will help the sales and services transformation accelerate going forward, especially towards new customer acquisition.

- **The cost of growth…again**. A further GBP50m cost savings are expected to occur in FY17. As management mentioned a two-year payback, this means Sage will incur up to GBP100m in restructuring and transformation costs this year - which we did not anticipate in our model - vs. GBP110m for FY16. As for last year, the operating margin in FY17 is expected to be below 27% in H1 while H2 is deemed to be higher thanks to the benefit of the transformation programme. Operating margin is set to increase and accelerate beyond FY17, but the timing remains unclear as it will depend on how Sage will modulate its digital marketing and new sales investments.

VALUATION

- Sage's shares are trading at est. 13.9x FY17 and 12.3x FY18 EV/EBIT multiples.

- Net debt on 30th September 2016 was GBP397m (net gearing: 38%).

NEXT CATALYSTS

Q1 FY17 trading update on end January 2017.

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