



Sohn Conference | November 30th 2017

Sean Lim
London School of Economics
S.Y.Lim3@lse.ac.uk

Sohn Conference Ideas Contest Finals



Business and Situation Overview

Sage is a software business that has been transitioning from a license-based to “SaaS” sales model

Underlying Business



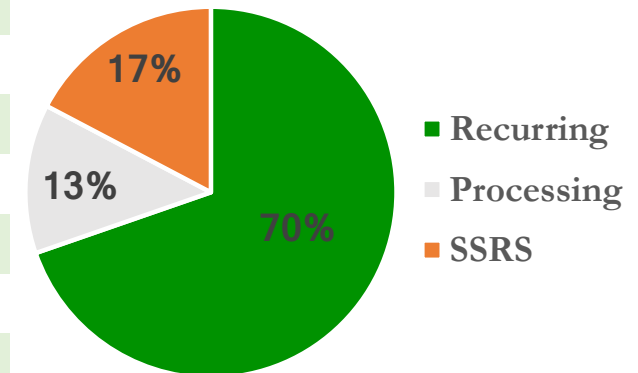
The Sage Group Plc is a UK-based company that sells **Accounting, Payroll, Human Capital Management, and Payments Software**, to mainly Small-Medium Enterprises (SMEs) in 23 countries.

Financial Snapshot

Sage Capitalization Table

Share Price	£7.54
Shares Outst.	1,080M
Market Cap	£8,146
Debt	£647
Cash	£309
Enterprise Value	£8,484
EV/NTM Sales	4.7x

2016 Revenue Segments



Why does the opportunity exist?

- **Operational restructuring benefits** are obscured from financials, as margins are “artificially” being depressed
- **Competitive concerns** from fixation on head-to-head product comparison overstates competitive threat
- **Years of disfavour** for slow transition to SaaS and Cloud. Market plagued with “Old Sage’s” sluggishness

Thesis Summary

- **Underestimated Margin Potential** allows us to invest in a technology business with materially higher earning power
- **Overblown Competitive Threats** overlook the runway of growth for Sage, supported by secular industry tailwinds
- **Underappreciated SaaS Business Qualities** are bound to be revealed as Cloud revenues sharply accelerate

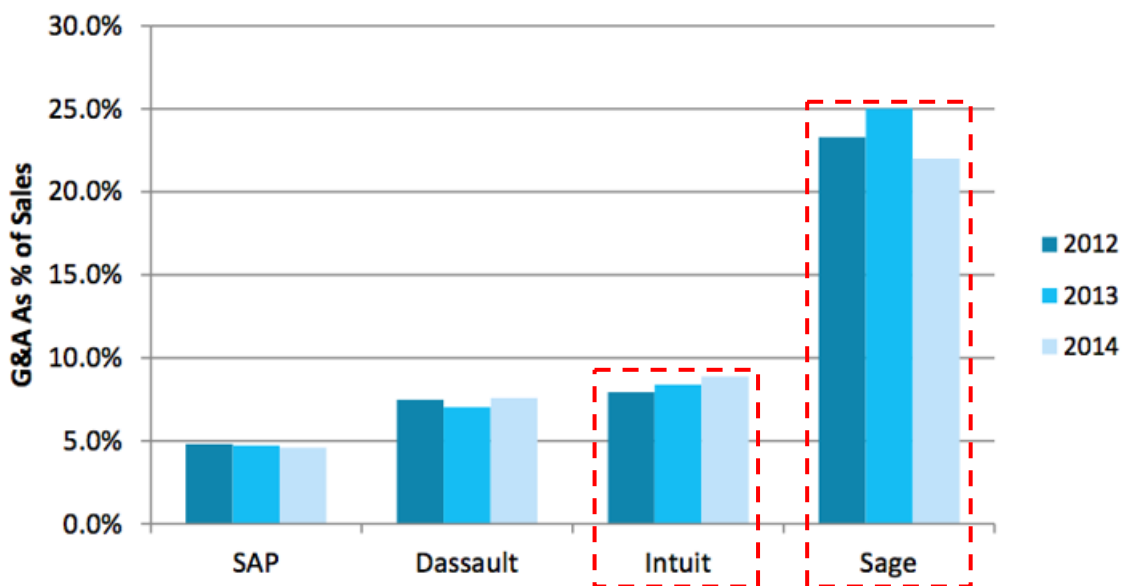
Part I

Underestimated Margin Potential

Underestimated Margin Potential

Context: In FY14, New CEO took over with ambitions to revitalise business and streamline operations

“Old Sage”: Inefficient operating model



“New Sage”: Restructured business with new operators

- **Footprint Optimization** → 139 to 78 Premises
- **New Management** → Replaced 72% of Top 100 Execs.
- **Staff Overhaul** → 22% staff attrition (fired) in FY16
- **Remodeled Sales operations** → 21 Decentralized CRM systems streamlined to 1 central system

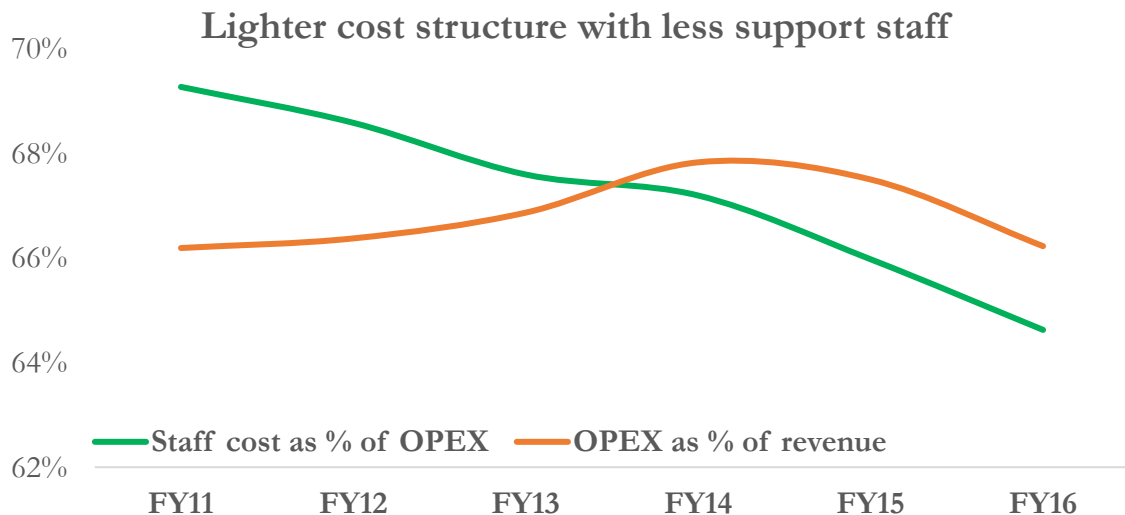
“The organisation... was **fragmented, misaligned and inefficient**, in part due to **dozens of acquisitions that had not been integrated**”

– Stephen Kelly, CEO (FY 17 Call)

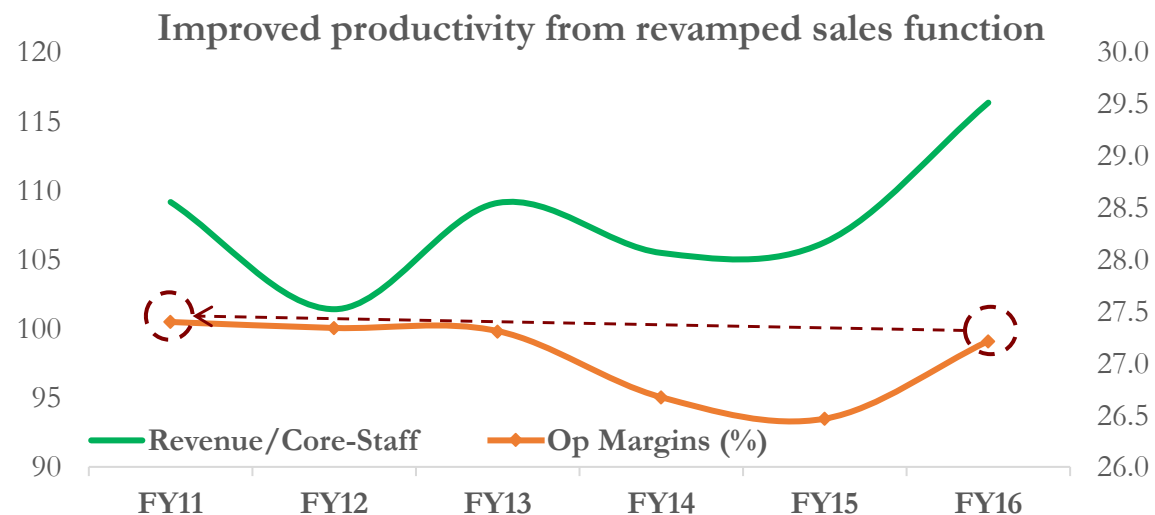
Underestimated Margin Potential

“New Sage” is more cost efficient with improved sales productivity. Yet, this is obscured from financials

Reduced staff cost from OPEX not passed through



Revamped sales productivity not reflected in margins



Major operations restructuring and staff overhaul should have created two-fold improvement in margins

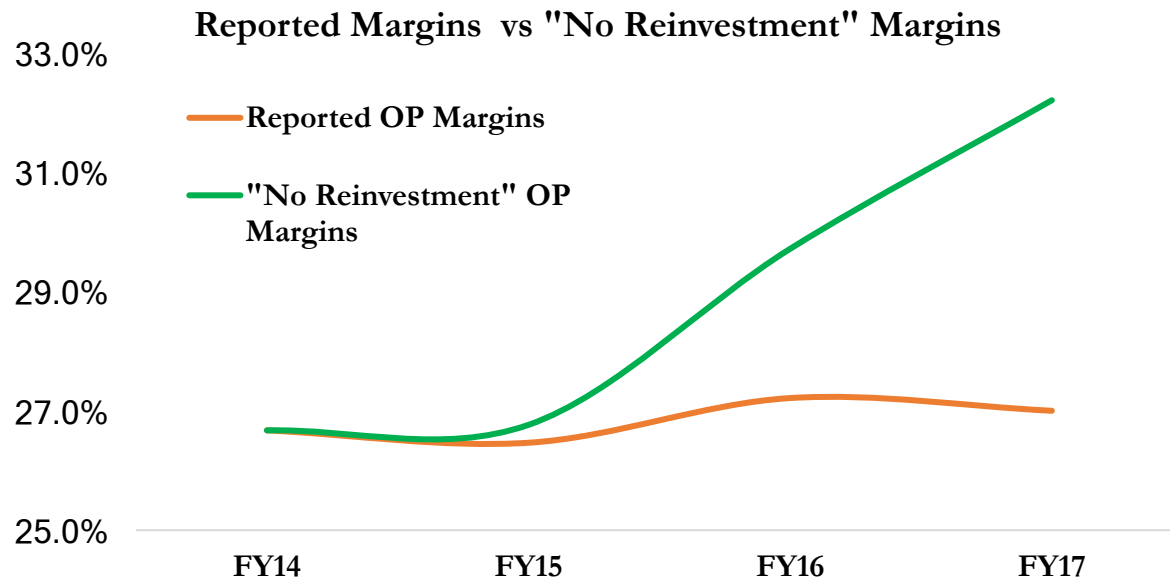
- I) Reducing bloated number of **excessive** support staff → Reduced cost base without impacting revenue
- II) Improved sales productivity (sales/employee) → Directly accretive to margins

“ (On increasing margins) **We’re choosing not to at this time because we think it’s better to reinvest for growth**”
– Steve Hare, CFO (1H16 Earnings Call)

Underestimated Margin Potential

Sage's Earning Power is artificially depressed due to management's choice to over-invest

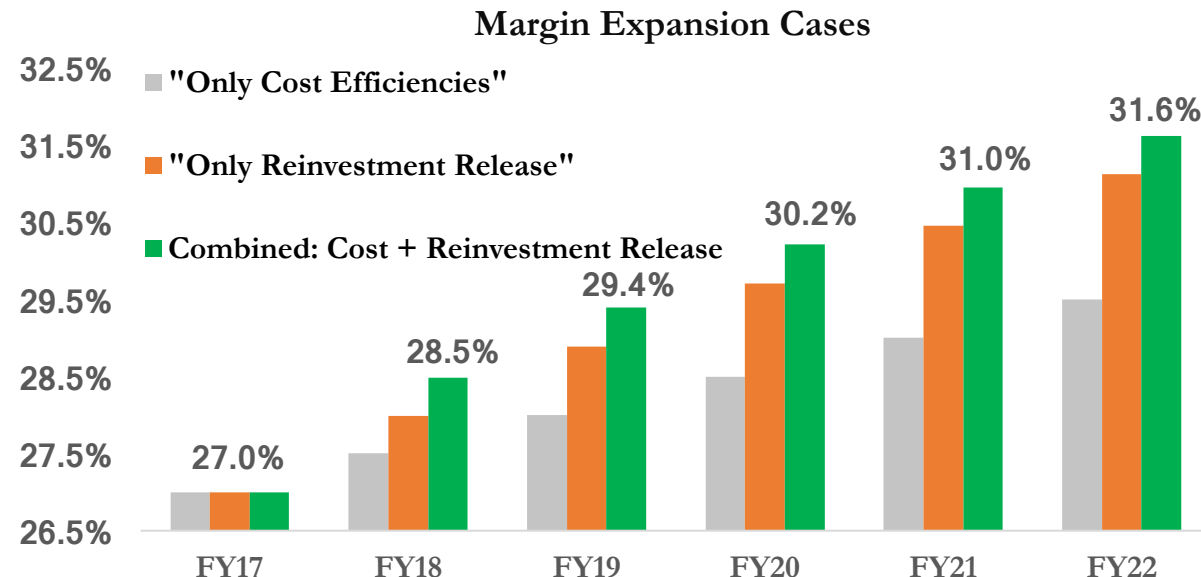
If cost efficiencies (G&A) were not reinvested....



“ There’ll come a point where we don’t need to **over-invest**...eventually, I’m sure, an operating margin will begin with a ‘3’ ”

– Steve Hare, CFO (FY15 Earnings Call)

Multiple ways to reveal margin potential



Driver 1: Allow G&A efficiencies (from consolidating operations) to pass through to margins, instead of reinvesting.

Driver 2: Release past reinvested efficiency gains from go-to market functions that have been established in the past 3 years

Driver 3: Operating Leverage (not captured in above chart)

Underestimated Margin Potential

With key investments completed, Sage can reveal its new margin trajectory from FY18 onwards

Past Efficiency and Productivity gains reinvested

H1 16

Product	USA	UK & Ireland	France	Spain	Germany	Canada	Brazil	RSA	Australia
Pegg 🧐									
sage One	✓	✓	✓	✓	✓	✓	✓	✓	✓
sage Live									
sage X3 Cloud	✓	✓	✓						
sage 50c	✓	✓							
sage 200c									
sage Accountant Cloud									

FY17: Completed go-to market investments

FY 17

Product	USA	UK & Ireland	France	Spain	Germany	Canada	Brazil	RSA	Australia
Pegg 🧐	✓	✓	✓	✓	✓	✓	✓	✓	✓
sage One	✓	✓	✓	✓	✓	✓	✓	✓	✓
sage Live	✓	✓	✓	✓	✓	✓		✓	✓
sage X3 Cloud	✓	✓	✓	✓	✓	✓	✓	✓	✓
sage 50c	✓	✓	✓	✓	✓	✓			
sage 200c	✓	✓	✓	✓	✓	✓	✓	✓	✓
sage Accountant Cloud	✓	✓							

Past efficiency/productivity gains that were reinvested in go-to market functions (Sales&Marketing Expenses) are mostly completed

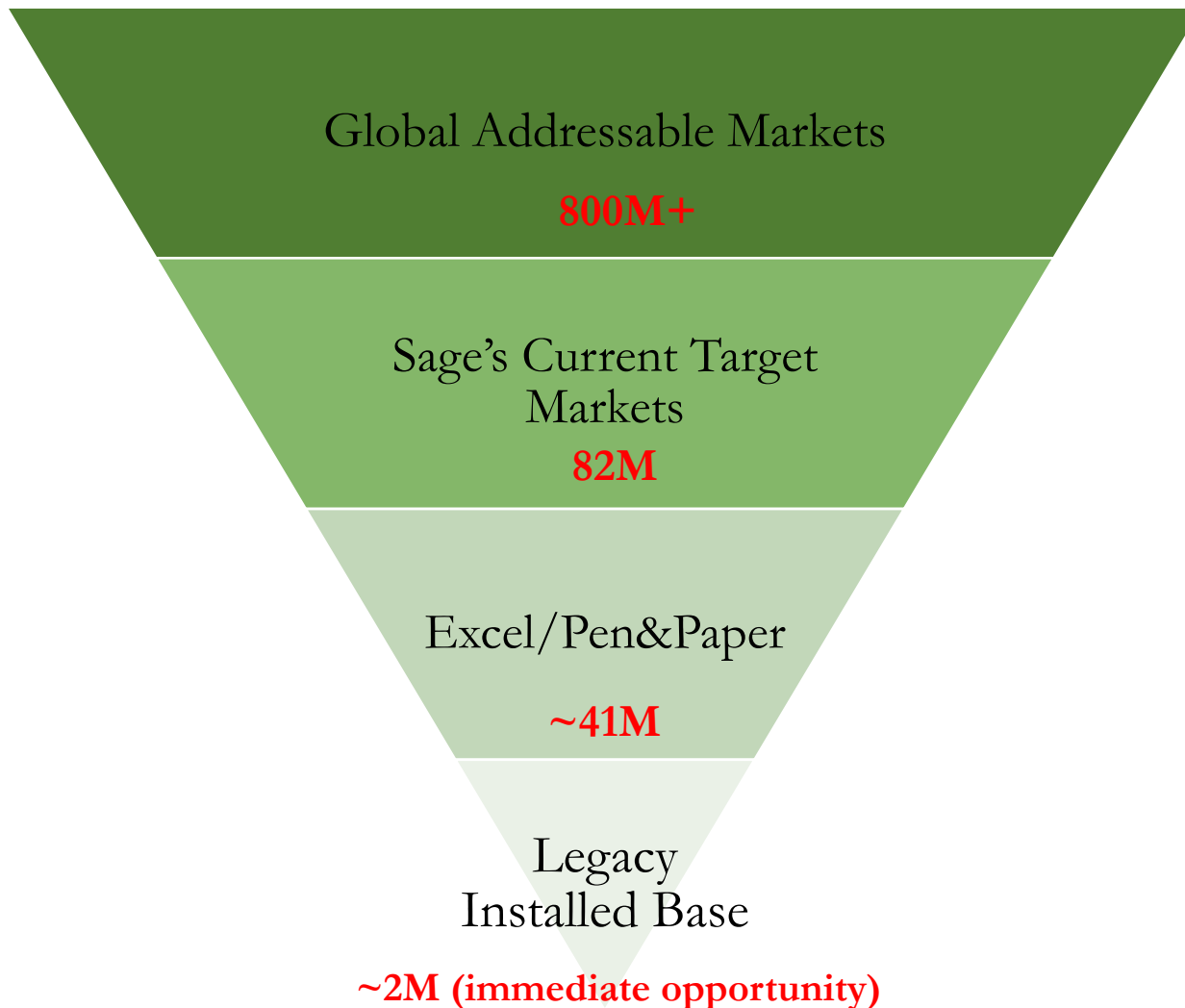
Restructured Sage is on an entirely different margin trajectory. Past efficiency and productivity gains, and continued G&A reductions, can now be passed through to margins.

Part II

Overblown Competitive Threats

Overblown Competitive Threats and Underappreciated Growth

Large TAM is severely underpenetrated, with ample “White Space” for Sage and peers to sustainably grow



Low penetration: All major competitors agree that penetration is in the single-digit percentages

Fragmented market: “Top 3 providers only account for 1/4 of market spend”- IDC (Industry Experts)

“Shift to cloud is accelerating accounting software adoption.....particularly in self-employed segment”
– Intuit (FY17 Investor Presentation)

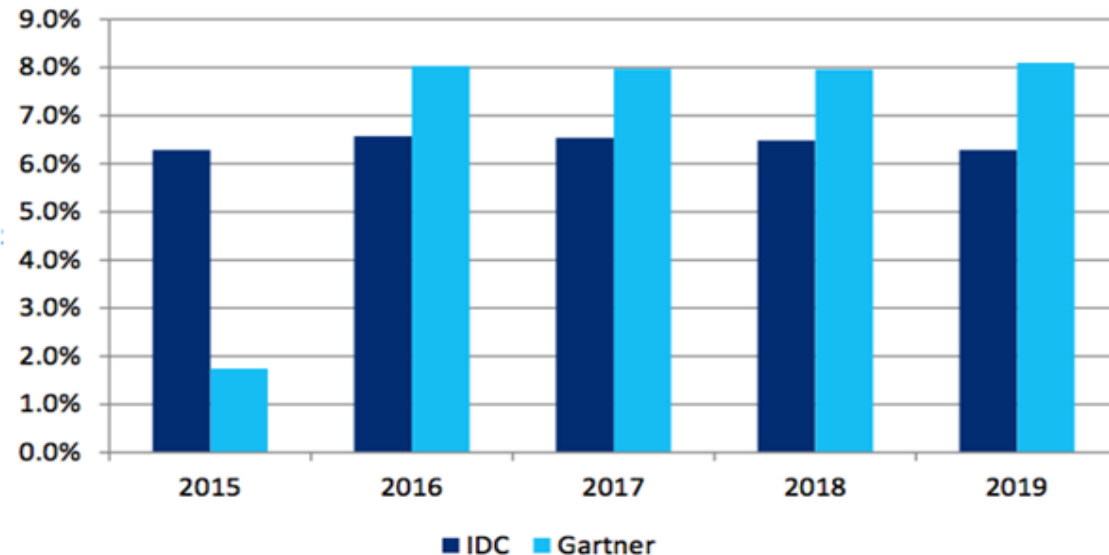
“Half of them (SMEs) have no accounting product. . . They run it on paper or on spreadsheets”
– Stephen Kelly, CEO (FY15 Analyst Day)

2/3 of Sage's installed base are on legacy non-subscription products → “Easy growth” by shifting them to attractive new cloud products

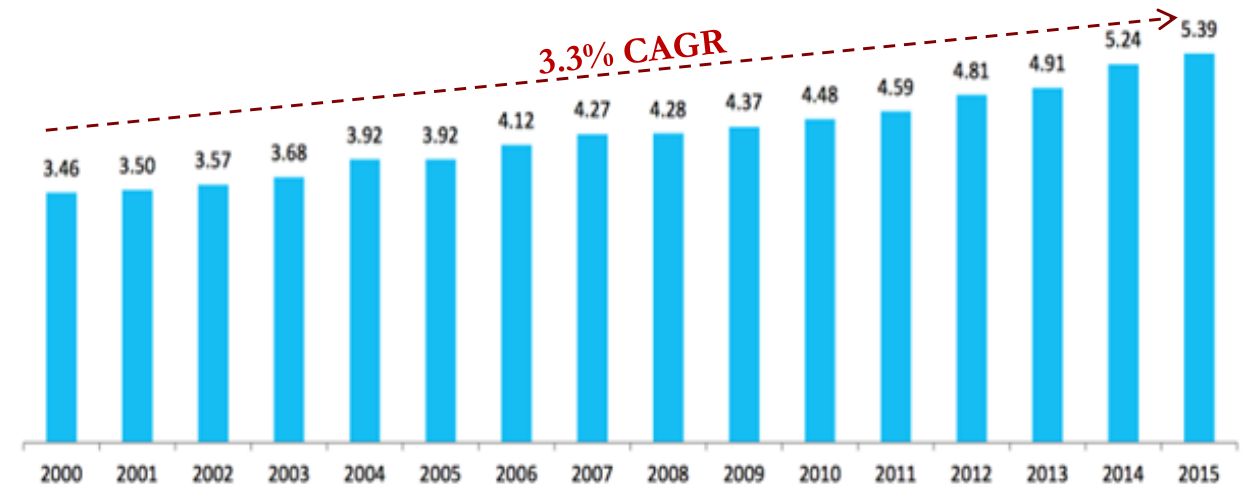
Overblown Competitive Threats and Underappreciated Growth

TAM is also not in a fixed state, but is steadily expanding due to industry tailwinds

SME IT spend growing at ~2x GDP (Gartner)



No. of SMEs historically grew at ~3% CAGR



“What’s driving spending is the fact that both cost and ease of use have reached a point where **SMEs without business software feel ancient** in a digitalized business landscape”
– Software Channel Partner (GLG Expert)

Structural TAM Expansion

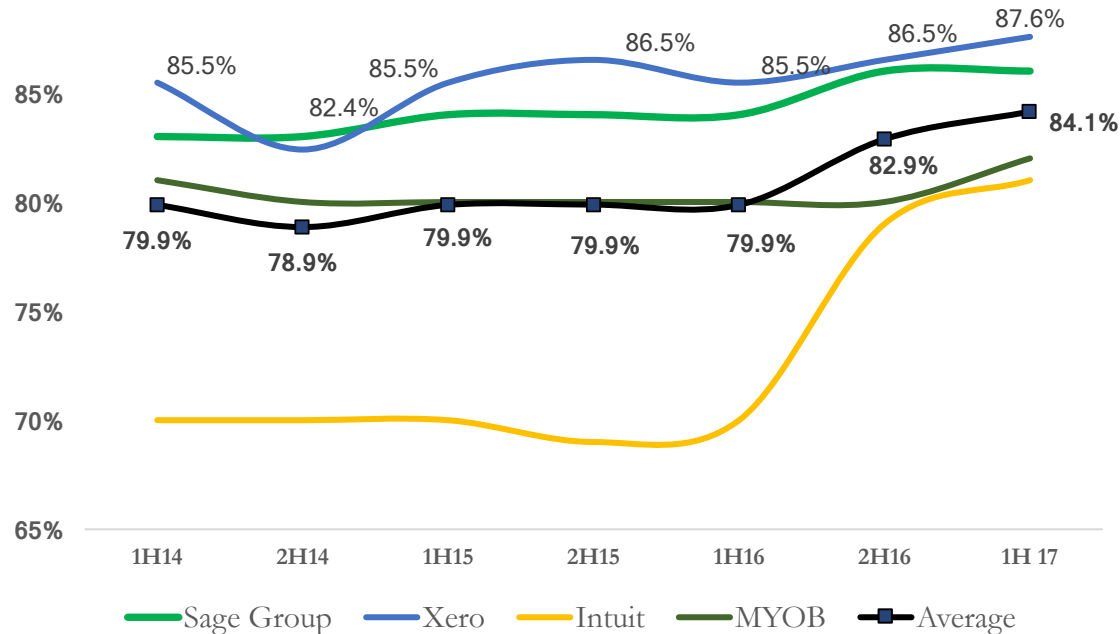
I) **Increase IT Spend per SME:** Digitalization of business landscape = cross-sell/up-sell opportunities

II) **Increase in number of SMEs:** Stable 15-year CAGR of ~3% net growth rate (gig economy)

Overblown Competitive Threats and Underappreciated Growth

Retention rates don't lie: Customers are increasingly being retained, not competed away

Rising retention rates amongst all peers



Industry-wide rising retention implies...

- 1) Customers are switching less to alternative products
- 2) Legacy customers are satisfied with today's product offering to renew existing contracts ("Roll-over")

Key Takeaway: There was a window for customers to be "competed away", but they chose to stay on

"Many new accounting software clients were previously just on basic Excel.."
– Accountant Channel Partner (GLG Expert)

Fixation on head-to-head product comparison over-intensifies the level of competition.
Industry should be able to grow sustainably without sacrificing product economics.

Part III

Underappreciated SaaS Business Qualities

Underappreciated SaaS-Business Qualities

SaaS benefits have yet to be recognized. Market remains plagued with negative perception of the “Old Sage”

Benefits for the Customer

Licensed-Based Delivery Model	SaaS-Based Delivery Model
Large upfront investment in IT infrastructure (Capex)	Small monthly or annual payments (Opex)
Requires knowledge to takes on risks of managing IT assets	Vendor responsible for automatically updating IT systems

Benefits for SAGE

Licensed-Based Delivery Model	SaaS-Based Delivery Model
One-off license spend with limited revenue visibility	Recurring spend with high level of revenue visibility
Multiple versions and code bases to manage and support	Homogenous set of products running on single code-base

“We’d **fallen behind**..Back in 2014, we had **become known as a sleeping giant...arguably a cloud denier**”

– Stephen Kelly, CEO (2Q17 Call)

“Our **Sell thesis on Sage** has been predicated on the view that no software company has yet successfully transitioned to the cloud ... **Sage's weak product position in the cloud was also a concern**”

– UBS (3Q17)

Underappreciated SaaS-Business Qualities

Market will start taking notice from FY18 onwards, as incremental revenues will be driven by cloud products

Sage has established a sales foothold in all key geographies

FY 14

Product	USA	UK & Ireland	France	Spain	Germany	Canada	Brazil	RSA	Australia
 Pegg									
sage One	✓	✓	✓	✓	✓			✓	✓
sage Live									
sage X3 Cloud									
sage 50c									
sage 200c									
sage People									
sage Intacct									

FY 17

Product	USA	UK & Ireland	France	Spain	Germany	Canada	Brazil	RSA	Australia
 Pegg	✓	✓	✓	✓	✓	✓	✓	✓	✓
sage One	✓	✓	✓	✓	✓	✓	✓	✓	✓
sage Live	✓	✓	✓	✓	✓	✓		✓	✓
sage X3 Cloud	✓	✓	✓	✓	✓	✓	✓	✓	✓
sage 50c	✓	✓	✓	✓	✓	✓			
sage 200c	✓	✓	✓	✓	✓	✓	✓	✓	✓
sage People	✓	✓							
sage Intacct	✓								

From virtually nothing (~2M) in FY14 to ~300M in FY17, Cloud products will be the key driver of incremental revenues from FY18 onwards.

Underappreciated SaaS-Business Qualities

How much value do Cloud Subscribers really add? A deeper dive into unit economics

$$LTV - CAC = \left[\frac{1}{Churn} \times ARPU \times Margin \right] - Acquisition\ Cost = \sim Value\ per\ Subscriber$$

NOTE: Took Xero's (LTV-CAC) formula for comparability purposes

Why do Cloud products have more attractive unit economics than License-based products?

- **Churn:** Perpetual licensed products have a higher churn as they can still be used even when support contract ends. The **large upfront spend** required also **forces customers to heavily compare products with competitors**
- **ARPU:** “Cloud accounting software is the backbone of an ecosystem of several other integrated applications” – GLG Expert. Multiple code-bases of **licensed software can't offer the same cross-sell opportunities**
- **Margin:** As opposed to managing multiple customized versions of licensed software for different clients, Cloud software is managed homogenously with automatic upgrades, leading to **structurally higher margins**
- **Acquisition Costs:** Marketing spend to acquire customers depend on whether customers have previously purchased legacy software from Sage. **Acquiring “Off-plan” customers should be cheaper than pure new adds**

Underappreciated SaaS-Business Qualities

Ramping up on Cloud Products will drive ~28% upside from new subscriber additions with higher CLTV

“There is no doubt that **Cloud products are drastically more valuable than licensed software** in terms of **both lifetime value and lower acquisition costs**...almost incomparable”

– Accounting Software Specialist (GLG Expert)

1. Off-Plan Customers (~1M) are “easy adds” to Cloud product subscriber base

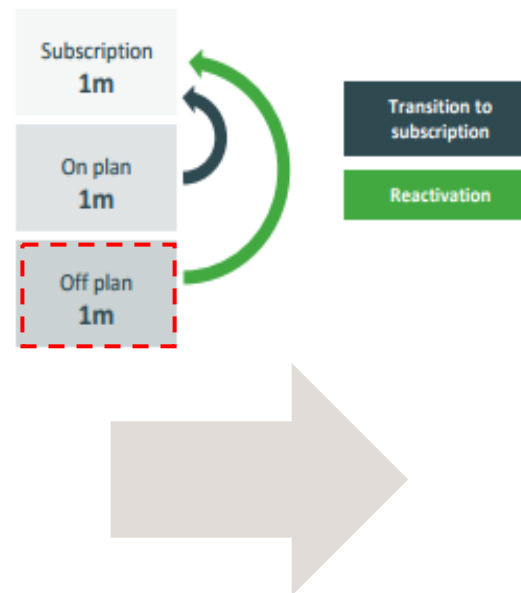
- Customers currently using Sage’s legacy software or other services, but no longer generate any revenues

2. Conservative Unit Economics Assumptions

- ~5x LTV/CAC **VS** Xero’s ~6.3x to 12.2x range (Group VS Domestic Market ratios)

3. Sharp Acceleration from FY18 Onwards

- Cloud product roll-out in key geographies
- “Making Tax Digital” in the UK (FY19)



Upside from Cloud Customers in the near term

Customer Lifetime Value	1,588
Off-plan Customers to Cloud	1,000,000
Pure New Customer Additions	500,000
Total Cloud Customer Additions	1,500,000
Total Value Add	2,382,328,168
Current Enterprise Value (in £M)	8,477
Upside	28%

Core Assumptions

ARPU= (£30 x 12)

Churn = 1- Retention= ~15%

Blended Margins = ~82%

Weighted CAC= ~£392

Part IV

Valuation & Catalysts

Valuation

Sharply discounted SAGE represents an attractive opportunity to BUY before clear drivers hit financials

Summary of Valuation

The Sage Group PLC	Bear	Base	Bull
Part I & II) Margin Expansion & Strong Retention Rates			
FY22E Sales (excl. Cloud contribution)	2,087	2,295	2,405
5 Yr CAGR	4.0%	6.0%	7.0%
FY22 Operating Profit	584	757	842
OP margin (%)	28.0%	33.0%	35.0%
FY22 LTM EV/EBIT	18.0x	25.0x	25.0x
PV Enterprise Value	6,530	11,757	13,069
Upside from restructuring & steady retention	-23%	39%	54%
III) New Cloud Subscriber Adds Only			
New Cloud Subscriber Adds (M) by FY20E	1.0	1.5	1.5
Value/Sub	1,000	1,588	1,700
Upside from new subscriber adds	12%	28%	30%
Total Return ~3 years (I + II + III)	-11%	67%	84%
~Total Annualized Return	-4%	22%	28%

What actually moves the needle?

I) Margin potential hitting the financials and post-restructuring uplift

- Renewed margin trajectory for Sage
- True earning power of Sage is no longer concealed
- Strong comfort with multiples: Steady LT Historical Avg. of INTU post-transition/ Xero's Acq. Multiples

II) Sustained Competitive Position

- Perception of competitive threats would rationalize as retention rates are sustained or strengthened

III) Cloud Subscriber Adds (Legacy + New Customers)

- Unit economics more attractive than old product suite
- Sage no longer “sluggish” as Cloud accelerates in FY18

Base Case provides ~22% IRR over next 3 years

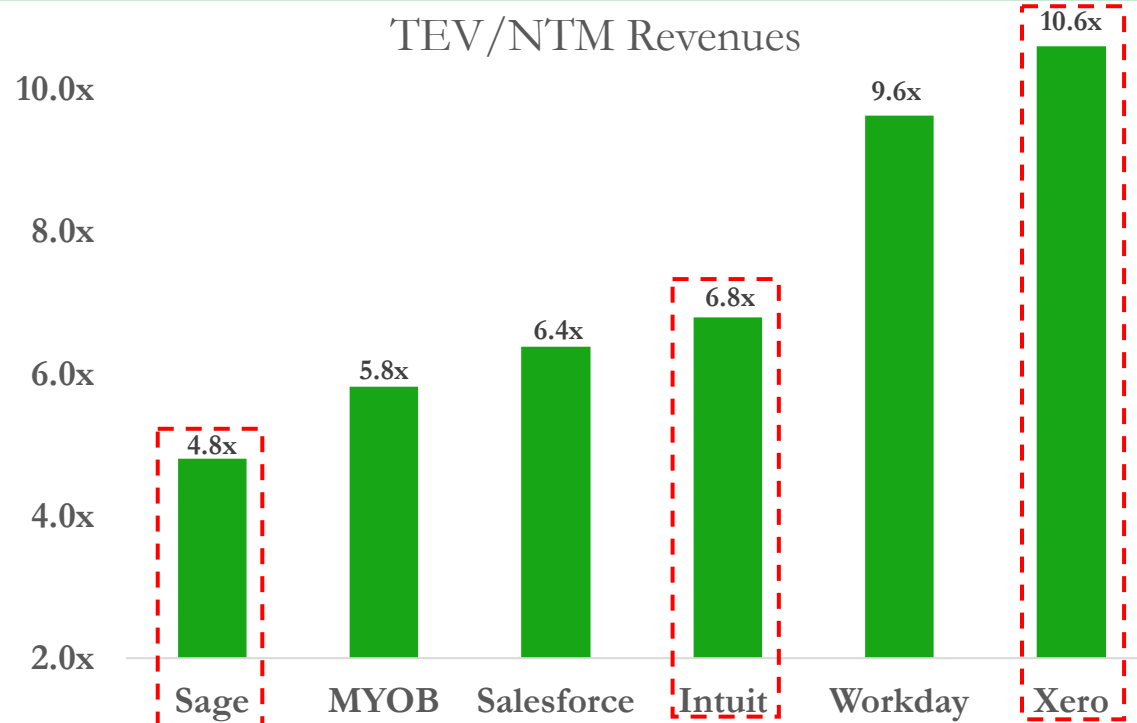
Catalysts

Sage has been written off in transition years as a sluggish industry laggard, so why invest now?

Key Catalysts

- **Completion of investments** will allow productivity and cost efficiencies to hit the financials from FY18 onwards
- **FY18 Cloud product roll-out** will sharply accelerate, and become the key driver for incremental revenues
- **“Making Tax Digital” (FY19) in UK** would strongly bolster FY18’s cloud roll-out momentum
- **Sustained industry growth with strong retention rates** provides clarity on overstated level of competition

Sage: Out-of-Favour Cloud Software Player



Invest at an inflexion point and reap benefits of a more profitable Sage post-restructuring, with a modernized product offering, in a structurally expanding industry

Special Thanks

The Sohn Conference Foundation

Gerson Lehrman Group

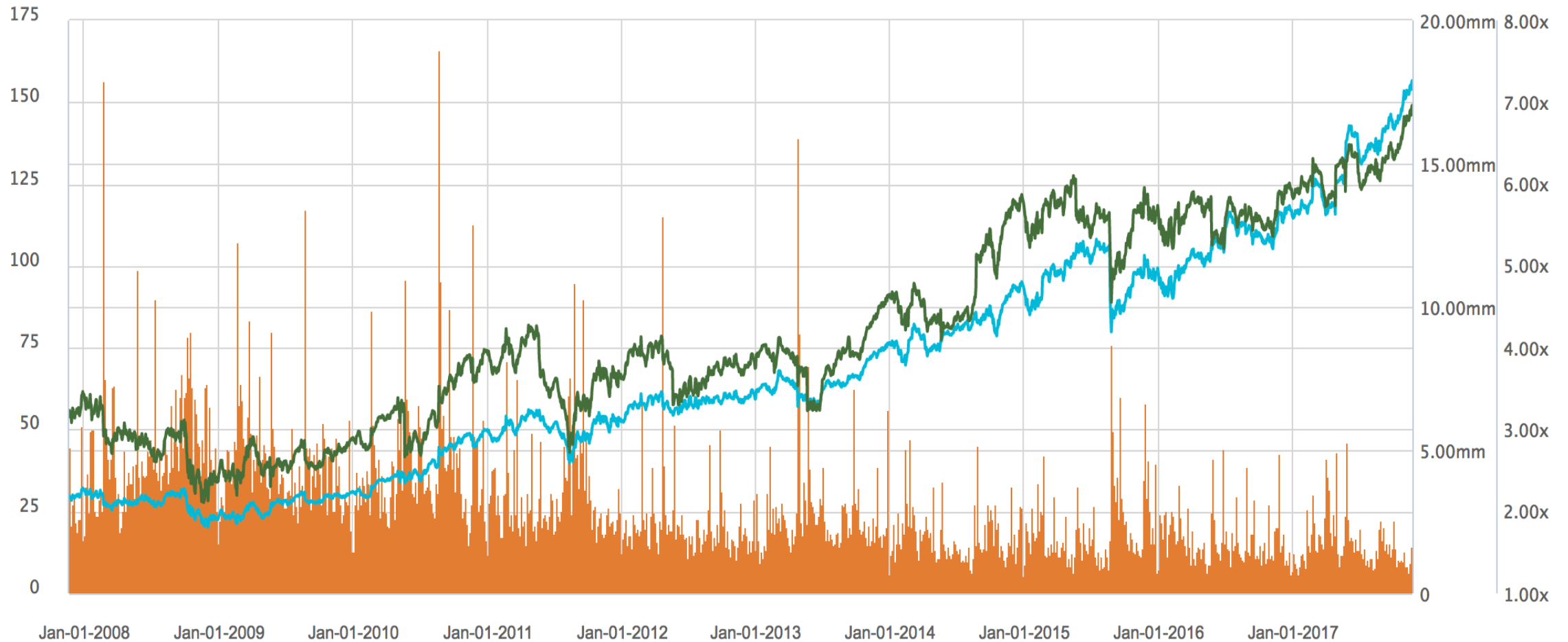
Tong Lap Him

Dylan Adelman

Global Platinum Securities

Appendix

Intuit's transition to the cloud from the early innings (EV/NTM Sales & Price chart)

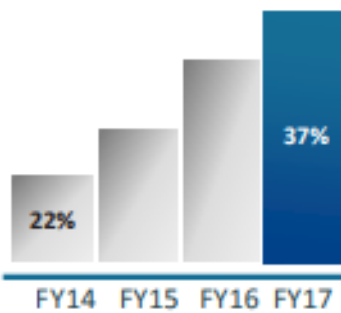


Appendix

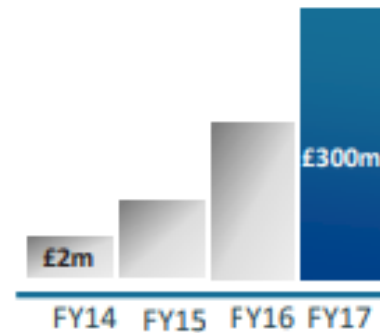
A high quality tech company does not stay cheap for long

Shift to more attractive Cloud unit economics

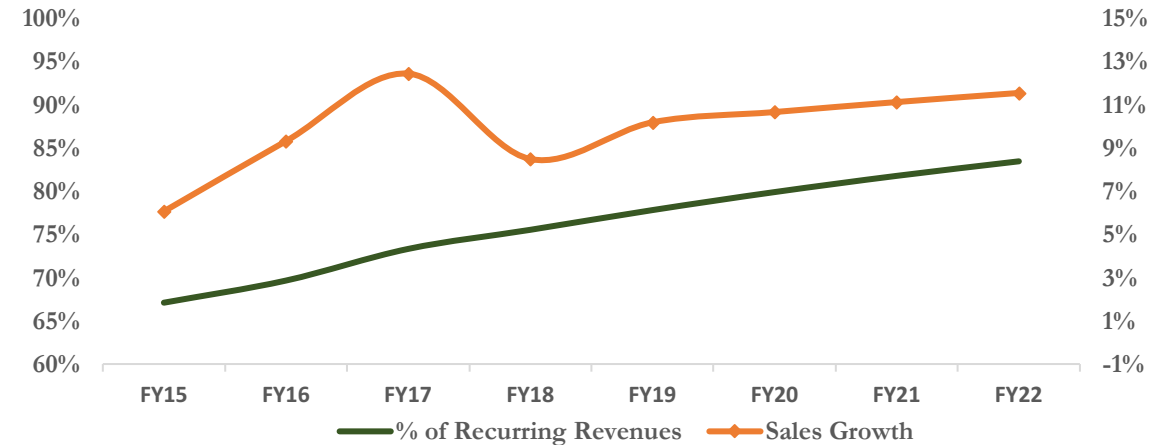
Software subscription penetration



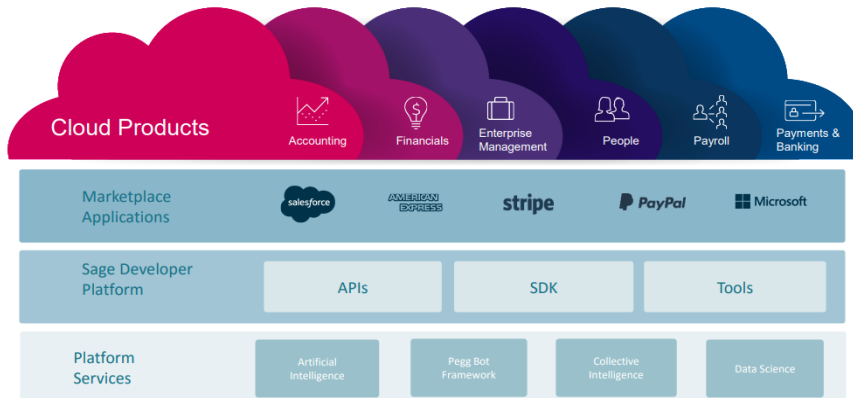
Sage Business Cloud ARR



Recurring revenues driving future revenue growth



Revamped Cloud Product Portfolio



Industry tailwinds in a large underpenetrated TAM

