Investors' Chronicle | Alpha

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Staying the distance

This week we look at resilience – how well set a business or market is to fend off or limit the impact of consumer spending pressure or even a full blown recession. Some are naturally resilient because of the necessity or indispensable nature of their product, others benefit from shifting market undertows that offset macro changes while others simply work exceptionally hard to make their products more popular, even elevating them to classic or cult status. Necessity offers the best defence, perhaps even assuring growth regardless of the economic climate, shifting trends ultimately run their course but give near-term protection and while sweating a fashion brand can keep up momentum, trends can change on a sixpence. Three somewhat different dynamics here but it does feel that slow, staid and steady will win the race, long-term.

- **Britvic (BVIC)** – a leading brand owner and big name distributor in the soft drinks industry, Britvic manages to extract good growth from a very mature industry: soft drinks demand just about tracks GDP. That said, a bias towards at home consumption did mean that the hit from Covid was limited. Strong demand for lo/no sugar drinks, a fight back in the energy drink segment and growth in an exotic market should combine to allow Britvic to post comfortably double-digit EPS growth. Soft drinks feel like a fairly defensive market and here the PE and growth rate look to be out of kilter, potentially leaving some value on the table.

- **Sage (SGE)** – good accounting software is a business staple and with very 'sticky' customers, providers enjoy predictability and long-term visibility. Not an industry given over to revolutionary change, but migration to cloud and SaaS models that investors rate more highly than a perpetual licence is rolling ahead at a decent pace. This is a steady, reliable business and while 8-10 per cent growth might be considered low for a software/technology business that growth feels more dependable and the rating is much lower than that given to, primarily US, whizz-bang technology stocks, many of which are yet to turn a profit.

- **Dr Martens (DOCS)** – management has done an excellent job of pushing an iconic, but very British shoe onto the world stage. The home market (now pretty mature) only accounts today for one in six sales with growing penetration in large international markets largely due to DOCS reducing wholesale, third-party sales in favour of a direct-to-customer business via owned stores. Good control of costs, which are essentially locked down fully for FY 2022/3, means little risk here of a profit warning (not so elsewhere in retail) but all fashion faces stiffening headwinds on cost and consumers' spending power. Internal hard work could still counter market pressures but consensus forecasts do feel a little rich. The best time to buy looks to have recently passed and although the rating appears low there are risks here, not least a large stock overhang.

Analyst: **Robin Hardy**

Britvic – still plenty of fizz?

Source: FactSet

Britvic is something of a UK staple. This FTSE250 listed stock is a leading brand owner, manufacturer and third party distributor of soft drinks. The UK is the dominant part of the group at 70 per cent of revenues (£1bn of £1.4bn) from owned brands such as Tango, Robinsons, R Whites, Plenish health shots, J2O, Ballygowan water, Drench and London Essence tonic waters. In addition, Britivic is a lead distributor and bottler/canner for global brands such as Pepsico (sole rights in UK and Ireland), DrPepperSnapple and Unilever.

It is the UK's No. 2 soft drinks company behind the sprawling Coca-Cola, holding an 18 per cent market share (Source: Neilson) against Coke's 30 per cent. Lucozade Suntory is in third place holding around 7 per cent. So the top three players in the UK are dominant, with over half of the UK's soft drink revenues. The total market value of soft drinks in the UK is around £13bn (which includes bottled water and tea/coffee) and globally industry sales are around $35bn-$40bn annually

Outside the UK Britvic's main focus is on Brazil (its most recent addition and a strategic area of focus – see later) along with France (recently rationalised – white label business sold off – c.14 per cent of sales) and Ireland (c10 per cent). Britvic is also an exporter of many of its owned brands (to over 100 countries) and operates as a third party distributor in a number of overseas markets – this accounts for just 3 per cent of sales.

In the UK and Ireland, sales are made through all channels (grocery retail, convenience stores, pubs, clubs, fast food and restaurants) while in Brazil and France sales are mainly concentrated in supermarkets.

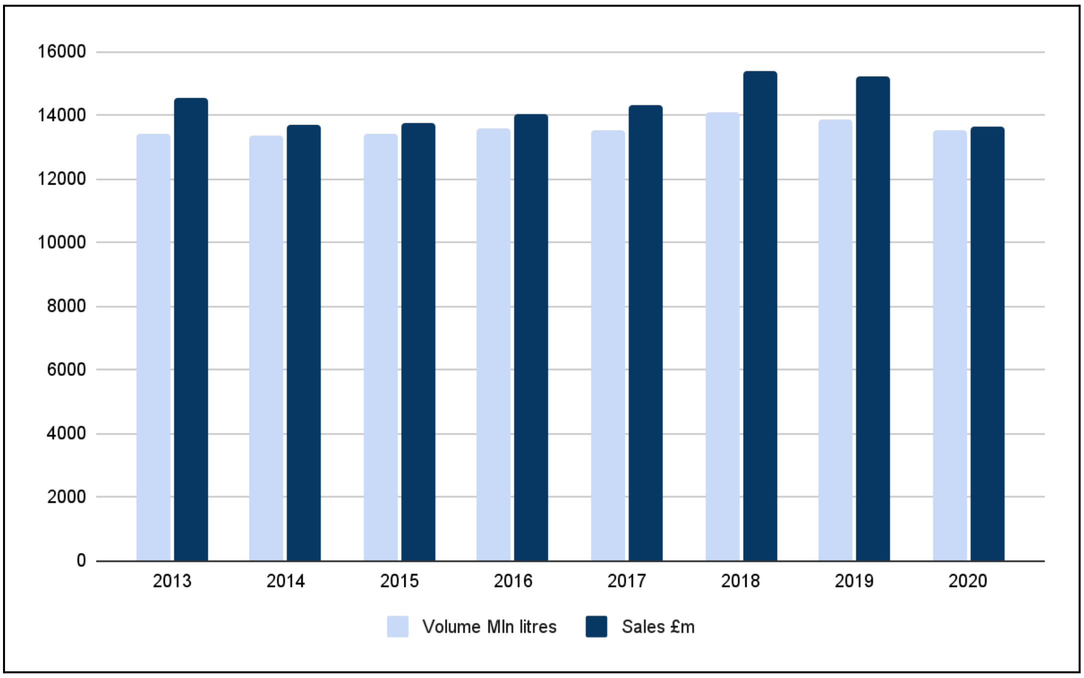
Resilience during Covid

During the Covid crisis, Britivic only suffered a modest dent in its sales (8.5 per cent) and 2021 proved to be broadly flat against 2020. Profits suffered more heavily, but that was more related to the higher cost of doing business in that period: staff shortages, freight costs, PPE etc.

Soft drinks' sales are split between 'on' sales (pubs and restaurants) and 'off' (at home or consumed on the move) and unlike alcoholic drinks which are 30 per cent 'on sales' and 70 per cent 'off sales', the skew towards 'off' in soft drinks is higher: in 2020 'off' stood at around 92 per cent against a long-term trend of around 15 per cent. Therefore, pub and restaurant closures had a smaller impact on soft drinks' sales versus alcohol. Indeed, people working from or otherwise trapped at home look to have slightly increased their consumption through the various lockdowns. Early in the pandemic there were reports of consumers stockpiling soft drinks, sometimes leading to shortages in store. Unlike in a recession, consumers stuck typically with branded products rather than shifting to more generic and own-brand alternatives. Own brand is generally not strong in this space (save for mixers such as Ginger Ale or Tonic Water), so consumer decisions are more typically to buy or not buy rather than switch.

Britvic estimates that 'on' sales of soft drinks through pubs in 2020 fell by around two-thirds and in the foodservice trade (restaurants, fast food etc) sales dropped by one-third. However, as the hospitality end of the industry generates higher unit revenue and is generally biased towards higher priced items than retail, while overall volumes in 2020 fell by just 2.5 per cent, the drop in hospitality sales caused industry sales value to drop by 10.5 per cent. This indicates that Britvic slightly outperformed the industry.

Figure 1: UK soft drink volumes and sales value

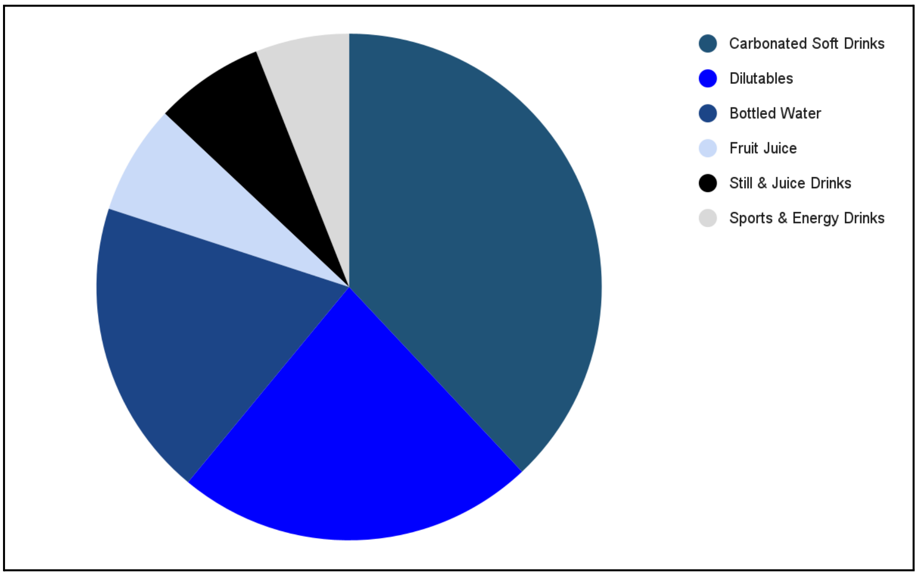


Source: BSDA

This chart shows that the UK drinks market overall is pretty mature and only has a long-run growth rate of about 2 per cent to 2.5 per cent, much in line with GDP growth. However, in the five years to 2019 total volume growth was only 3.5 per cent. The sales value of the market is growing a little faster as drinks manufacturers seek to push more premium brands into the mix but in that same five-year period, prices struggled to keep up with inflation.

There has been a significant shift within the market with low or no sugar carbonated drinks rising from around 44 per cent share a decade ago to now nearer 64 per cent. While this has not especially impacted industry volumes or sales values overall, shifts in market share that this has caused is a key element in the investment case for Britvic (see later).

Figure 2: The UK soft drinks market by type



Source: BSDA

Brazil

Britvic entered the Brazilian soft drinks market through two acquisitions in 2015 and 2017 buying a range of branded products, mainly flavour additives/squash, from Ebba and Bella Ischia. Management sees this a key area of growth even though only 8 per cent of revenues are today sourced here. Britivic aims to drive both organic growth by pushing more of its existing brands (some of which will be re-badged locally) into the market, using R&D to create new products and through acquisition of existing brands. Although the figures aren't published, analysts believe that margins in Brazil are meaningfully below the group average and can be brought more in line, largely through its operations having high operational gearing (large drop through from sales to profit).

This is also seen as a more dynamic market with soft drink demand rising at 5 per cent CAGR against the UK's 2 per cent. The group's brands are forecast to grow at nearer 10 per cent. The total market value for soft drinks is similar to that of the UK, but the population is more than 3x larger. Britivic's market presence is mainly in concentrates (squash or cordial) with limited business in ready-to-drink products: this is a major area of potential growth. Another source of potential is the regional nature of markets here with few nationally recognised brands – in all other markets Britivic has been successful in promoting products nationally. Low sugar and natural flavourings also present a powerful opportunity here. Finally, Brazillians are generally on a health drive with many people aiming to reduce alcohol consumption.

There is a lot of potential here and double digit organic growth potentially topped up by bolt-ons should be useful in pushing up the overall growth rate. However, this remains a small part of the group even if it is promoted as a key growth area. Brazil does feel less resilient than the UK and during Covid, soft drink sales fell sharply across all channels as the economy declined and unemployment rose more sharply and there was far less government underpinning of wages. So, this is interesting and useful but doesn't feel like it is enough to really move the dial.

PepsiCo alliance

Britvic has exclusive distribution rights for the UK and Ireland for the entire PepsiCo brand portfolio of sparkling drinks. This encompasses the eponymous Pepsi (classic, diet and the fast growing Max), Lipton ice tea, 7-up, RockStar and Mountain Dew. There has been a relationship with PepsiCo since 1987 and the bottling and distribution agreement was recently extended out to 2040.

This set-up looks to drive around a quarter of the group's total revenue and although it is dealing with a third-party brand, analysts believe margins are similar to those from owned brands. Pepsi products are the single largest block of sales for Britvic.

This is an important part of Britvic's business but does potentially warp the dynamics for investors. First, while the agreement appears watertight for now, it can end either by falling out and by PepsiCo being taken over and there is a finite life on the contract, albeit one well beyond the investment horizon. Secondly, it creates something of a 'poison pill' for Britvic that largely precludes it from being a takeover target – Pepsi can terminate on any change of ownership and must be consulted before any takeover is recommended by the board.

Overall, this is a mutually symbiotic relationship and is a net positive for Britvic, but as a fair amount sits outside of the group's control, it can be argued that earnings are of lower quality than those fully controlled.

Sugar, tax, energy and premium products

While the soft drinks market is showing only very moderate growth overall, there are substantial changes in the market structure. New generation products are changing soft drink sales enabling those aligned with the changes (as Britvic appears to be) to outpace the market.

Sugar – As mentioned above, lo/no sugar drinks are growing rapidly as are 'energy' drinks (Red Bull, RockStar et al), sports drinks (Lucozade Sport etc) and natural flavourings. The introduction of the UK sugar tax has played a part in this, but primarily it is lifestyle choices from consumers and ESG pressures on producers that have been the key drivers.

Britivic has been active in converting most of its own brands to healthier alternatives and has been instrumental in getting PepsiCo to create healthier options of its offerings. This has seen one of the group's strongest growing items play a major role in the relative strength of Britvic's sales – the growth of PepsiMax. This drink has strongly outplayed Coke Zero in the new-gen sugar-free market (focusing more on male consumers) although it still lags behind classic Coke and Diet Coke by some margin. In 2019, PepsiMax increased sales by 19 per cent and in 2020 'at home' sales grew by 14 per cent, double the market rate of growth for lo/no drinks. Britvic leads the industry in the mass of sugar per can/bottle across its own and third party brands: today >90 per cent of its products are below the sugar tax threshold.

Energy drinks – another growth sector is the somewhat euphemistically entitled 'energy' drink segment – in reality these are caffeine or taurine laden drinks that allow the candle to be burned at both ends, and often in the middle. Here Red Bull dominates controlling 45 per cent share, with Monster in 2nd place with 30 per cent. Britvic's interest is with the somewhat distant No. 3, PepsiCo's RockStar brand which holds a 7 per cent share and Richemont's Purdey's at around 2 per cent.

Purdey's has been showing very strong growth (>20 per cent CAGR) and RockStar could/should recover lost ground to the industry leaders now that the powerful combine of Britvic and PepsiCo has taken the brand from AG Barr (BAG). So, there is scope to outperform here. The UK 'energy' drink sector has been growing at around 6 per cent CAGR, but is beginning to mature although it may perk up a little as the sector transitions to low sugar. Britvic looks well set here but sales are only around £25mn-£30mn (group sales >£1,400mn) so overall, this segment will not alone shift the group's fortunes.

Premium push – this is focused in the dilutables (squash or cordial) segment, which as shown in figure 2 accounts for almost a quarter of the UK soft drinks market. The owned brand Robinson is the market leader in the UK. New formulations and a brand refresh looks to have brought the loss-making Robinson's brand back into the positive and this should have a positive effect on the overall rate of EPS growth.

AquaLibra

In something of a tangential move Britvic invested in 2020 in a consumer products business – the Boiling Tap Company, since renamed Aqua Libra. This is not to be confused with the flavoured sparkling water brand the group already owned. This is a company that aims to sell to consumers, retailers, gyms, service stations and the hospitality industry specialist taps that can deliver plain, chilled, sparkling, flavoured and boiling water from a single spout.

The plan here is to play a more active part in the reduction of single use plastics, still a major thorn in the flesh of the soft drinks industry, and capitalise on the growing trend of own-container bulk-buying, something today largely restricted to dry goods. Poor recycling characteristics of the plastic used in drinks bottles (PET) are driving the industry to look for better solutions and this is certainly innovative. But it is small at barely 0.5 per cent of the group's NAV, but if successful it could create a value well in excess of the maximum £14mn purchase price. Don't hold your breath on this but it does show some creative thinking by the board.

Steady growth outlook

A stable but uninspiring overall market backdrop augmented by Britvic being well-aligned with positive industry gyrations and the strength of the relationship with a giant such as PepsiCo leaves the group offering attractive growth prospects with relatively low risk. There is a squeeze on consumer income but is more likely to hurt the less important 'on' trade sales and net-net is more likely to drive sales for home consumption up. A full-blown recession would be a greater concern as brand names tend to lose out to own-label/cheaper alternatives or (more likely) outright loss of sales. That said, through the global financial crisis, Britvic's sales grew from £716mn in 2007 to £1,290mn by 2011, with earnings before interest, taxes, depreciation and amortisation (Ebitda) following a similar track. However, that was pretty much the last time that there was much in the way of top line growth – in the eight years from 2011 to 2019 sales grew at just 2.2 per cent CAGR (tracking the wider industry) with EBITDA fairing only a little better at 3.6 per cent CAGR. The outlook is better: for the current year, Ebita growth is forecast to be 13 per cent, although some of this is inevitably rebound from Covid. In the following two years, growth drops to nearer 6-7 per cent, but this is still suggesting industry-beating performance.

EPS performance is looking somewhat better than this with the income statement leveraging a flat depreciation charge and falling interest costs – while net debt looks only to be stable at either side of £500mn, Britvic has been re-issuing its debt at progressively lower rates with lengthening maturities over the last decade. So, between FY21 and FY24, Ebitda growth of 27.5 per cent (based on consensus) translates to EPS growth of 43 per cent: that is 12.5 per cent CAGR.

It is important to highlight that all of the above numbers are made on an adjusted basis with the main alteration being to reverse out exceptional items. A slight problem here is that Britvic seems always to have exceptional items hitting its profits – when there is a constant stream of exceptional items, by definition they cease to be exceptional. While they are arising generally from different sources each time, investors should be wary of perpetual adjustment. These adjustments do seem to be continuing, albeit at a lower level but are still pushing the profits up from the statutory reporting by around 5 per cent.

It is also notable that the momentum in the consensus is gently negative with estimates today around 3 per cent lower than they were 12 months ago. This is likely a reflection of a tightening consumer environment and greater inflation through the supply chain that is going to become harder to recover. That said, we are looking at a slower rate of growth rather than a swing from progression to regression in all forecast years.

A more affordable dividend

Britvic is not a great yield stock, paying only around a market average 3.25 per cent prospective, but looking forwards the payments are becoming much more affordable with DPS cover in the current year set to hit 2x. Cover is then forecast to remain at this level. We must highlight, however, that this is still a rebuilding dividend following the cut in 2020 from 30p to 22p. In 2019, DPS cover had dropped to just 1x on basic EPS, but that year did contain a large exceptional item (£84mn). By the end of the forecast window (2024) the yield should have increased to 4 per cent.

Valuation and conclusions

Britvic is a very stable business in a stable if unexciting macro environment, which is subject to some consumer-led and wider economic headwind risk. However, its own dynamics look good, good enough and resilient enough to sustain EPS even if the rate of growth could be clipped a little further. Investors get exposure to this on a PE of 15x dropping to 13x or on an Ebitda basis 10.3x falling to 9x, although as we highlight above PE is probably a better gauge here given the high leverage between Ebitda and net income.

The share price chart at the head of this article may indicate a stock just moving sideways, but in reality this stock has given a total shareholder return over the past five years of just over 40 per cent or a healthy 7 per cent per annum. The return is split pretty evenly between capital and income.

A PE of 15x for 12.5 per cent CAGR is undemanding rather than outright cheap, but you do get what look to be pretty defensive earnings. The shares are probably worth somewhere between 900p and 1000p (824p at the time of writing) suggesting scope for just about double digit TSR on a 2 year view. However, we should point out that around one third of the analysts forecasting on this stock think that the value has already become exhausted and see little or no upside. There also seems to be limited scope for an upgrade cycle in the near-term so no likelihood of a re-rating, but there is still value here, in our view.

Sage – a picture of resilience?

Source: FactSet

Think 'accountancy' and staid, solid, stolid and dependable comes to mind. Evolution, not revolution. A business tied closely to accountancy leaves one thinking of something cautious and resilient and, given the nature of and need for accountancy in business, this is not a service area that business customers can readily do without, almost regardless of the economic climate. Books must be kept, invoices raised, cash tracked and accounts compiled. This is the world of Sage, the long-established FTSE100-listed, but globally present business and financial software (today it provides far more than just accounting software with a major presence in HR systems).

Used to be a darling

The chart at the head of this article might suggest that Sage is a stock that is busy going nowhere. The share price today is broadly where it was five years ago and the total return over that period has been just 2 per cent (total, not per annum); that said, this still beats the FTSE All-Share which has returned -3 per cent in the same period. Comparisons with the UK technology sector are unhelpful as this is heavily skewed by the collapse in value of Micro Focus. The MSCI Global Software & Services index is up 100 per cent over the same period, so Sage's performance is not great.

It used to be very different with Sage's share price rising over eight-fold from the end of the financial crisis in 2009 to its recent high point at the end of 2021. The shares have seen a great deal of volatility in the last five years as rising competition and various management disappointments (under the previous regime) saw investors unhappy with strategy, relieved at the arrival of a new CEO, hit by profits warnings, cheered by a cleaning up of the balance sheet and boosted by hefty share buy backs all of which have kept the share price chart resembling a roller coaster.

More recently, the stock has been clubbed together with the rest of the technology sector, falling from its all-time high in January (852p), tumbling by almost one-third year to date. This was a combination of recessionary fears, concerns over staff costs/availability in IT and rising benchmark interest rates used to value technology stocks on a discounted cash flow (DCF) basis. Even though Sage is a mature business and not one showing the huge rates of growth some US peers present, many of its followers still use DCF as a core valuation tool, possibly because of its very steady and (usually) predictable cash flows.

So, has the market been unfair to Sage in bringing down its share price at the same time as the many frothy, often over-hyped and frequently heavily loss-making stocks in the more exotic parts of the technology sector? Probably it has, because this is a stock with an almost metronomic beat at its core augmented by a slow, steady expansion of services, progressive conversion to more attractive (in investor's eyes) billing structures (ie SaaS) plus the occasional bolt-on acquisition to add new services. Financial software may not be exciting or headline grabbing like AI or machine learning but is indispensable for all small to medium sized businesses, Sage's constituency.

Solid core

Sage customers are very 'sticky' with exceptionally low rates of churn. This allows it to present very high levels of recurring revenue, something that the market has long been drawn to within the technology sector. The shift to SaaS models and the revenue reliability they offer is a key attraction and differentiator in this space. Last year Sage classed some 92 per cent of its revenue as recurring, although in practice it is closer to 100 per cent as the other 8 per cent is in the effectively terminated professional services and licences arm. Many other technology businesses can only dream of such levels.

In financial and accounting software there is, by the nature of things, very little 'churn' of customers – it is generally too disruptive for a larger or medium-sized business to migrate to a different platform and as long as the services Sage provides work and are accurate (and they are) customers will simply stay put. While that does provide resilience, it does mean that Sage has to work harder to grow its revenue, doing so incrementally - this is achieved by broadening its services, upselling to existing customers and fighting with its competitors (primarily Intuit QuickBooks, Xero (both global) and Wolters Kluwer in northern Europe) to secure a share of the many new companies formed each year. For context, in both the UK and USA each year 600-800,000 new companies are formed and while many are small to micro, it does illustrate the scale and pace of new corporate life. Also each year many thousands of businesses expand and cross the threshold into Sage's target market.

Another change driving businesses of all sizes to take out or expand financial software from Sage *et al* is the growing requirement for businesses to use electronic invoicing. This is where accounting systems generate, distribute and book all transactions and also record payment receipts and chase unpaid bills automatically. Not only can this improve cash flows materially for companies, it is increasingly a requirement for being able to do business with many larger organisations and, especially, when undertaking government contracts. This is likely also to lead to many businesses needing to pay for accounting software themselves rather than rely on an external accountant who would deal with paper-based transactions.

One of the key elements we are looking at this week is business resilience and given the needs for all small- and medium-sized businesses to run accounting and financial software and the inherent 'stickiness' of customers, Sage does come across as especially resilient. This is underscored by the group's core, recurring revenues holding very steady during the Covid crisis in 2020 and 2021.

Small and micro businesses

Most of the businesses serviced by Sage are in the larger- to medium-sized businesses – this means those typically with more than 50 employees and revenues most likely of £10mn or higher. However, there are far greater numbers of smaller and micro-entity businesses in all local markets that are gradually drifting across into the use of professional accounting software, more particularly cloud-based accounting. Many of these businesses are likely to have been using more basic, locally installed software but the likes of 'making tax digital' in the UK and similar enforced changes elsewhere are forcing ever smaller businesses to take up recurring subscription services. The UK VAT rules change in 2019, for example, is believed to have forced 1.1 million businesses to take out a subscription-based accounting service.

A great advantage for Sage is that the 'engine' driving its web-based solutions requires very little incremental cost to adapt to slightly smaller businesses. While Sage has largely eschewed much smaller businesses, there is great potential here to tack on core accounting services. This is a potentially substantial untapped area, and one in which its competitors (especially Intuit Quickbooks) have cornered the market. There has been a conspicuous shift in the marketing of the group's services that do look to focusing more on much smaller businesses. There are now frequent adverts on TV, radio and social media as part of a major brand refresh: its first common, global marketing campaigns with the 'boss-it' slogan in 2021 and the 'voices of business' scheme in 2022 with bold, primary-coloured cartoon voicing over real business customers should help to boost the customer base.

Cloud migration

Sage has been quite late to the party of moving software and services to the cloud (typically bracketed as Software-as-a-Service of SaaS) and was still selling boxed software for local install on a single perpetual licence within the last five years. As the chart in Figure 1 below shows, as recently as three years ago more than half of the customer base was still using fully locally installed software. In software terms this is close to the dark ages with manually installed patches and upgrades, no visibility of renewals and telephone-based help desks. More than a quarter of Sage's customers run fully local systems but through the ending of upgrades and withdrawal of support for older services, migration to full or part-cloud systems is likely to be a useful longer-term driver of revenues.

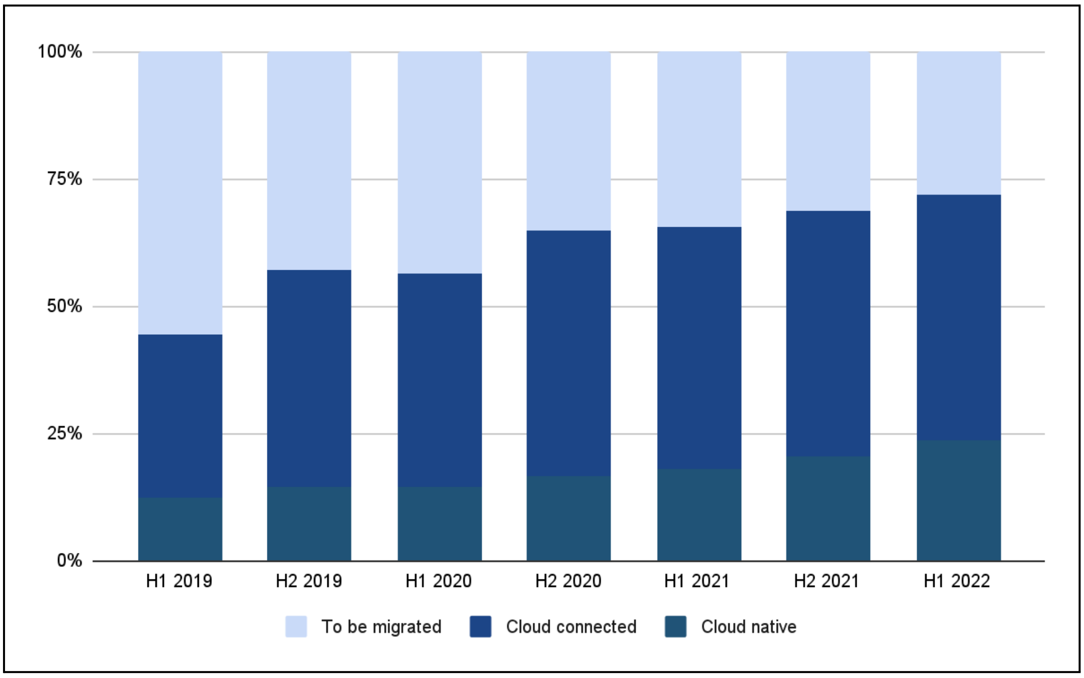
Sage really began its journey towards being a SaaS provider in 2017 when it purchased the fully cloud-based ('cloud native') accounting and financial software business Intaact for $850mn. This was a necessary step as new customers to Sage had previously only had access to what is called 'cloud connected' solutions. This is essentially local software with a few cloud-based overlay services and is a long way from a full SaaS platform. This has allowed Sage to move many of its customers across to a subscription model as the bolt-on cloud services have become more central to customers' requirements.

Even though SaaS is seen as the model of the future for financial software, Sage is still growing customer numbers and revenues in its more basic 'cloud-connected' segment (+13 per cent in the last six months) although much of this will have been through migration from legacy systems (around 10 or the 13 per cent). The difference in the growth rate of true SaaS is profound with cloud native systems (mainly Sage Intaact) growing at more than 35 per cent per annum. This is much faster than the estimated 12 per cent market segment growth and suggests that Sage is winning back market share losses, particularly to Quickbooks and Xero. The growth rate for all accounting software and services is around 6 per cent per annum.

The policy of migration from legacy to cloud native or just cloud-connected is like a powerful internal heat source for the group. Legacy users might only renew their licences every five years at, say, $500 per seat giving $100 per annum per user + maintenance and support fees. The basic cost of Sage50Cloud (not fully SaaS) is around $340 per annum per user meaning that even without net customer additions, there is a steady source of revenue growth from migration that should last at least another five years.

Sage's cloud offerings have all of the usual cloud advantages of all serving the most up-to-date software, improved collaboration, mobility, data security, back-up/restore, elastic storage, operational commonality, disaster recovery/business continuity and rapid expansion or extension of services. The costs of operation for a user have been higher, but most customers seem to learn quickly that efficiency savings make the additional fees more than worthwhile.

Figure 1: Sage's rapid transition to cloud services



Source: Sage PLC

Leaning towards ERP

In broadening its services away from the core of accounting and financial management, Sage is becoming more like an ERP business. Although not offering the breadth of enterprise resource planning from the likes of Oracle or SAP, Sage is now viewed as being a top five ERP (some argue it is the global No. 3) offering inventory, manufacturing, business intelligence, and distribution tools. Its suite of HR tools are core to the operations of many of its customers. Where it lags the industry leaders is the ability to service very large and very complex businesses as its focus is on the inherently less complex medium and smaller business sectors. Nonetheless, offering a broader service with a steadily increasing array of options (many in the cloud) helps not only accelerate potential growth rates, but also pushes up the quality of earnings.

Big data

The simple business of recording and tracking transactions, running payroll and cloud-based HR services create large quantities of relatively unstructured data. Within these blocks of data are valuable insights into how a business could be run better or where compliance requirements may be lacking. Sage has developed a suite of powerful analytics tools that can interrogate and extract useful data to improve business operations. This provides additional revenue streams, although it is more limited to those customers primarily using cloud-native services.

Access to this wider pool of business intelligence across all customers is also allowing Sage to develop a suite of industry-focused tools that deal with issues specific to an area such as construction, education and distribution.

Valuation and conclusions

Sage has proved to be resilient during Covid with revenues running broadly flat from 2019 to 2021 as net customer addition slowed and conversions from legacy to cloud services were deferred by many customers. Nonetheless, this does highlight the very stable and resilient nature of this market segment and Sage within it. However, stability is not the same as growth and in the technology/software sectors many investors can see elsewhere sales and Ebitda continuing to grow at very high rates. Stability is good, but growth is better.

Although there is stability at the headline level here, rates of expected growth have been pruned. For the current year (to September 2022) the current consensus forecast is for EPS of 26p (unchanged on 2021); in November 2019 before Covid hit analysts were expecting 35.3p, more than one-third higher. Looking further ahead, there is a similar gap for FY2023 with today's consensus at 29.4p against 36.6p just before Covid. Most technology businesses have seen estimates trimmed but the reductions here seem severe. This is most likely due to forecasters' previous exuberance, expecting a pace of change that Sage was unlikely to deliver rather than the business itself actually stumbling. Fading forecasts typically lead to a de-rating but while estimates were being cut back, it is notable that Sage's share price raced away to an all-time high.

Looking at valuations, against its most direct competitors Intuit (US listed) and Xero (listed in Australia), Sage is cheaper on a PE of around 22x. Intuit trades on a forward PE of >30x and Xero around 100x (but it is growing materially faster – doubling in each of

2024 and 2025 – but is yet to break even for a full year). Both of these are more cloud-oriented and more SaaS-biased than Sage. Sage is actually a broader business than these and more mature, so potentially looking at broader ERP stocks could be more helpful? In the large-cap arena SAP trades on a 21x PE, Oracle is on 16x and looking at UK-listed ERP stocks:

Table 1: UK comparables

	PE Ratio
Ideagen	41.0x
Eagle Eye	60.6x
Craneware	24.3x
GB Group	20.5x
Gresham Technologies	21.9x
Sage	22.7x

Source: FactSet

This might make Sage appear relatively close to trading at its fair value and this feels fairly well-reflected in the analysts' ranking for the stock: four buys, three holds and three sells. That said, the half-year results in May did show further shifts towards the cloud, the group coming close to completing the sale of non-core businesses, recurring revenue momentum picking up to 10 per cent growth (long the holy grail rate of growth for management), hitting a 100 per cent renewal rate, cash conversion (from Ebitda) of 120 per cent and Intaact still growing at >30 per cent. That all augurs well for continued positive momentum in EPS and raises confidence that growth can continue even in the face of global economic headwinds - not all technology stocks can promise this. At worst, it feels as if the growth rate could be dented, but not the achievement of overall growth.

The balance sheet is strong with debt sitting at the midpoint between in the 1-2x Ebitda range set by management, which has been achieved despite funding a £600mn share buy back (always glad to see this as the capital return mechanism rather than special dividends) and the recent £225mn bolt-on acquisition of cloud-based retail sector specialist ERP software company Brightpearl. The high cash conversion means that Sage has around £600mn (and rising) of firepower each year to fund a blend of enhancing bolt-on acquisitions and/or further share buy backs.

Sage certainly looks to offer resilience because of the non-discretionary nature of its services and 'sticky' revenues but growth looks to be edging steadily higher with the long dreamed of target of 10 per cent now almost in hand. This is not a business with especially high operational gearing so margins also tend only to edge ahead but returns do seem capable of advancing by 50 to 100 bips per annum from an already very respectable 20 per cent at the EBIT level.

It might appear the best buying opportunity could look to be behind us with the shares having motored ahead by 45 per cent during 2021. However, almost all of that has been given up in the first half of 2022. While this is a technology stock in that it sells software and owns IP, it does not feel quite right that the great tech shake out that started in November should have been almost as severe here as for the more esoteric stocks that are still making losses and are likely to need to return to the market for fresh capital.

Many of these wilder tech stocks have started to rebound and while Sage has picked up a little, it is only around 7 per cent off its recent floor: some of the cybersecurity stocks we recently profiled (click here) are more than 25 per cent off their lows. Perhaps it's time for a little more catch up and the Sage share price could readily head back to the levels seen as recently as early May before the interim when the stock was around 100p or 15 per cent higher than they are today.

Continued on the next page...

Dr Martens – counter culture goes mainstream

Source: FactSet

The maker of the iconic, eponymous footwear Dr Martens listed in the UK in February 2021, but the shares have not fared well despite a very healthy start with a 22 per cent rise from the 370p IPO price on the first day of trading. The shares have not been back above the IPO price since January this year and only found a floor within the past six weeks at 183p, almost exactly half the flotation price.

Dr Martens has come to the market in turbulent times with 2021 still heavily impacted by Covid lockdowns, store closures and freight issues and, in 2022, geopolitical instability, high inflation and squeezed consumers have impacted here as they have across the entire apparel industry. The sector has recently seen a couple of profit warnings (ASOS and Zolando) but more are expected.

The investment and trading story here, however, do seem to have a little more substance and, despite no shortage of risk, there is a picture of well-managed structural growth here. With a fair wind, and assuming something approaching global stability and normalised inflation from the middle to end of 2023 onwards, there is still a chance that DM will be able to post some, albeit modest, EPS growth in each of the next two financial years. After that there is a decent chance that double digit growth is on the horizon largely driven by management action to push the brand harder into newer and seemingly eager local markets.

Taking greater control – direct to customer sales

A core part of DM's operating strategy has been to bring more sales directly under its own control through owned, branded stores and direct online sales. This has involved reducing the wholesale channel (allowing other retailers to sell through products) and buying back various franchised, own-brand stores most notably in Germany and Japan.

In addition to giving greater control over the brand and being able better to manage the brand identity, it is more profitable for the group, albeit only modestly. Taking the classic 1460 boot as an example (which accounts for around 43 per cent of sales alone) at the same retail price (today around £149 or local currency equivalent)the net revenue from direct supply is c.£124, while in the wholesale chain it is only around £40. That is not quite the whole picture as direct sales incur rent and staffing costs etc but there is still a considerable gap in favour of direct sales.

The swing to direct sales is enshrined in the group's DOCS operational strategy. While the 'D' makes a lot of sense the other legs of the strategy do feel a little more like Business 101.

> **D** - Direct to consumer first
> **O** - Organisational and operational excellence
> **C** - Consumer connection
> **S** - Support brand expansion with B2B - *interestingly this has changed since the time of the IPO when S = Sustainable global growth*

Building a controlled retail chain is a positive when things are on the up but can, of course, become something of an albatross should things turn around. DM does appear to have good and positive momentum at present so this is still a positive development but the first test will come into the autumn/winter/Christmas season for 2022. DM has historically been a less seasonal business than other fashion brands, but the opening of more stores does introduce more seasonal bias with Christmas falling in the group's 2nd half. It will be especially important to read the runes in the Q3 trading update on 26 January to see if the operational shift is still working.

Classics but fashion is fickle

DMs are presented as a fashion classic – cultural magazines have variously described them as 'sub-cultural fashion staple' and 'model off-duty staples' and the company pushes them for "when you have your rebellious moment". The shoes were 're-discovered' in the mid-2010s as celebrities embraced what had been previously a working class, functional staple. They are well-established now and powerful marketing (plus a kick from celebrity use) has pushed their appeal globally. However, they do nonetheless remain a fashion item and there is always the risk that the appeal will slip when another off-beat or counter-cultural or re-discovered brand becomes the new must-have.

DM has remained level headed, not allowing runaway prices for this footwear (unlike Australian brand UGG in the mid 2000s) and even being relatively high fashion, DMs still offer good value for money, high production standards and exceptional durability (and they can be repaired and/restored unlike, say Converse All Stars). They remain significantly cheaper than catwalk-cum-high-street brands – a pair of nylon Prada trainers will set you back £500, for example.

As a fashion item, there is some level of risk. This is a single brand, vertically integrated manufacturer-and-retailer and unlike other retailers if the heat of the single brand fades, there is nowhere else to turn. If the popularity fades the investment in own brand stores suddenly becomes a burden. This is a great unknown and is likely to be an issue that could drag on the equity rating, and as the period for which the brand has been in the spotlight lengthens, that pressure is likely to grow.

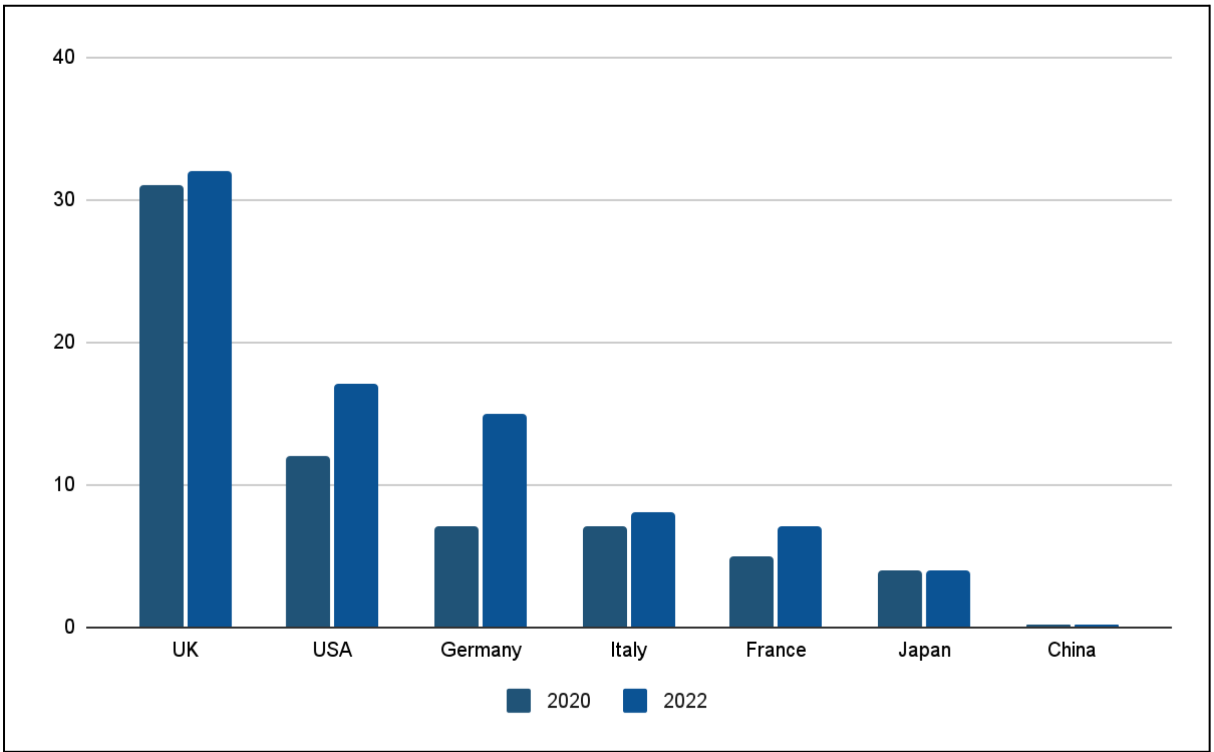
The likes of American Apparel, Forever 21, Abercrombie & Fitch and Quicksilver serve as great examples of how the mighty can fall. DM does not have any financial pressures (it has amazing cash conversion and is still heading for the great position of holding surplus capital and scope for capital returns), is not burdened with excessive manufacturing costs (almost all manufacturing is offshored to the Far East) and is not shooting itself in the foot through elitism and exclusion, so the brand feels safe now, but that is never assured.

Breaking new ground

The UK is still the heart of the business but is increasingly a mature market for DM. The brand has been selling overseas since the 1970s but largely remained a quirky minor brand in each of the six target markets (USA, Germany, France, Italy, Japan and China) with the previous management seemingly having no desire to develop an overseas strategy. In the past five years, this has been reversed and the sales explosion in the past two to three years shows that there had long been a missed opportunity. Products have long been sold overseas, but through the wholesale channel largely running with good control of the brand. This has helped further the direct to customer approach and store openings have been significant – there are now c.160 owned and managed stores with around 125 outside the UK.

As the chart below shows, this expansion has been successful and there have been healthy advances in market share in the target markets but as markets such as the US and Germany begin to achieve market penetration that gets closer to the home market, there must be a risk that the previously explosive growth begins to decelerate just for maturity and without any impact from economic headwinds.

Figure 1: Product penetration by market – pairs per 000 of population



Source: Dr Martens PLC

A structural growth story?

A key question to address here is whether this is a sustainable, structural growth story that will go on to deliver the potential that might be defined by the relative size of the seven target geographies and their fashion markets: if target penetrations are achieved that would easily deliver five to 10 years of well above average growth. The alternative is that DM is still, to some extent, cyclical - both economically and in terms of fashion and popularity. This does appear to be a business that is driving very hard and successfully to create brand and market presence and has done a great job of turning that into hard sales – the growth in Germany and the USA in particular highlight this. France and Italy are harder nuts to crack because of their history with core fashion and couture leaving less room for fashion counter-culture. However, in Italy DM is converting franchises to owned stores and that ought to inject fresh impetus.

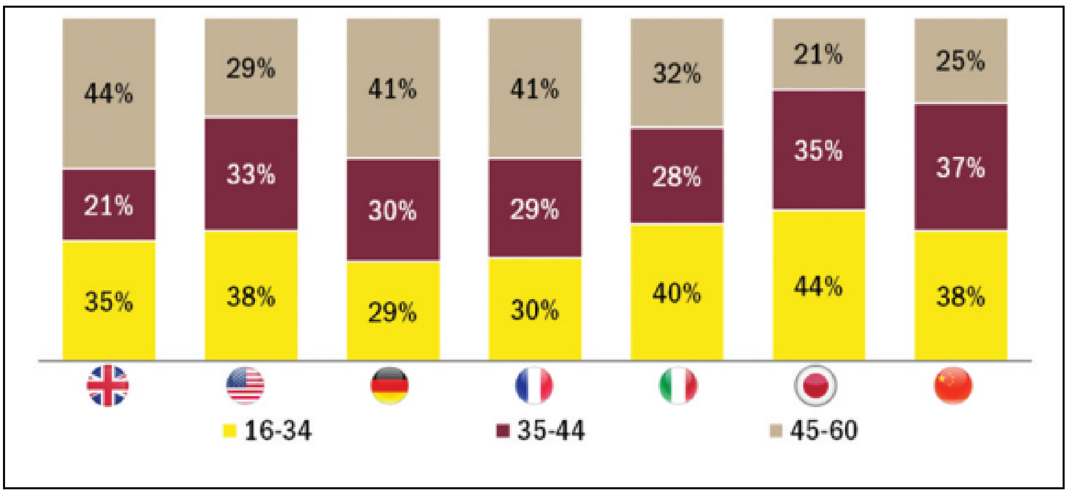
If DM is able to show that it can accelerate growth in these two markets, that would strengthen the argument for this being more of a structural growth story. Japan has also been tough but that may be because until this year it was 100 per cent franchised and looks to have lacked the right engagement by local management – going forwards, 75 per cent will be directly owned with the franchisees bought out. Japan is a highly conformist market and again sales growing rapidly here would be a good indicator that the growth story is strong and more structural.

China could be a key market with today only low market penetration but perhaps the largest potential – according to Statista, total shoes sales here in 2020 totalled 3.95 billion pairs. In FY 2022, DM sold 14.1mn pairs of shoes/boots globally. Even a very small market share here could add materially to the growth rate and the brand is already fairly well-established: FactSet estimates that sales in China already equal those in Japan and exceed those in Italy. China has the lowest (but still good) brand awareness at 63 per cent (UK = 93, US = 75, Germany = 66), but this is growing even though to-date sales in this market have all been made through third parties in the wholesale channel. This leaves DM without the control it would like to really advance the brand and store openings would be a major step. If China could reach even one quarter the pairs/000 of population achieved in its least successful market Japan, revenues from the Asia Pacific region could begin to rival those in the Americas and Europe, both now at around £400mn per annum: revenue in APAC today is around £130mn.

The shape of the buyer

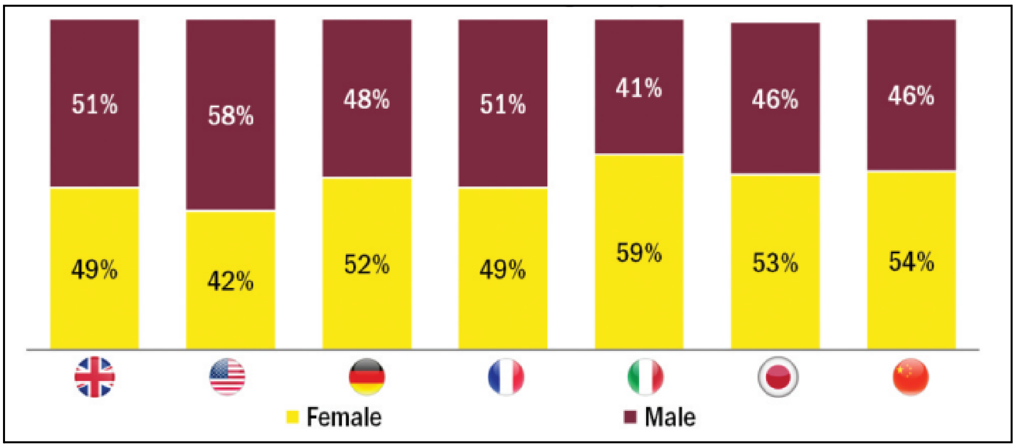
It is possible that the main buyers of DM's shoes are better protected from the worst of the pressures on consumer spending. Most buyers are either: young with many still living at home with parents but earning so that high inflation has less impact on but they still benefit from spiralling wages; or middle aged at peak earning power.

Figure 2: Dr Martens customer split by age



Source: Dr Martens PLC

Figure 3: Dr Martens customer split by gender



Source: Dr Martens PLC

Forecasting reliability - FY2023

DM's management has positioned the group very well to be able to meet, or come close, to consensus forecasts for the year ending March 2023. While revenues are still going to be subject to the vagaries of retail sales in the owned stores and a potentially tough winter, there is a great deal of visibility in both the levels of wholesale retailer revenues and in the cost base. The wholesale supply chain (still around half of revenues but dropping as DTC rises) is fixed (for price and volume) well in advance of the period end and by 1 June 2022 some 85 per cent of all wholesale orders for the year to March 2023 were locked in: 100 per cent is expected by late August.

Similarly, costs are locked in well in advance with some 95 percent of the current year's input costs having been locked in before the end of Q1. Overall, the group's cost of goods sold will increase by around 6 per cent in this financial year, but this is likely to be comfortably absorbed by the planned £10 price rise on core items coming later in the summer – this has already been priced into wholesale agreements.

Table 1: Breakdown of Dr Martens' production costs

Leather	35%
PVC	10%
Other materials	21%
Labour and factory profit	23%
Logistics	5%
Duty	6%

Source: Dr Martens PLC

So, the 2023 consensus estimates can be taken to be reasonably reliable, give or take, and to a large extent that is the number that drives the equity valuation and, perhaps more importantly at this stage, means that DM is unlikely to have to issue a profits warning unlike some of its peers. Profit warnings really only occur when the market estimates for the **current** year are materially wrong and likely to be skewing a stock's valuation. Unless something very material and very certain will impact later years, there is no need for management to comment on forecasts out in the market.

Forecasting reliability – FY2024

While things feel tightly locked down for 2023, the same cannot be said for 2024. No wholesale or supply chain deals are yet in place and there are risks here. If 2023 does not play out as expected, there is likely to be unsold stock in the wholesale market and orders for 2024 will drop. While DMs are 'fashion' but they do not go out of fashion and will sell equally well in the following year – around two–thirds of total revenues come from just half a dozen 'classic' styles (such as the 8-hole boot, the 1460 or the basic shoe, the 1461) that have not been changed in many years. Also if cost inflation is worse than priced into 2023 settlements, the supply chain will demand catch-up adjustments that are likely to be harder to pass through in price rises. While £149 is a reasonable price for the 1460 boot, a price approaching £175 feels materially more marginal.

The share overhang

Looking away from trading and more at the equity, DM has a large and overhanging shareholder in the form of Permia, the private equity house that brought the business to the market in 2021. Today its holding is 36.5 per cent, with a sale of 6.5 per cent having been carried out (clumsily according to some brokers) in January after the post-IPO lock-in period ended. The sale of £257mn shares was made at 25p above the IPO price, but c.25p below the then market price. The shares fell on the day and have been largely declining since.

Overhanging stock worries investors especially when the holder is a private equity investor, which is typically the antithesis of a stable and long-term investor. Their very nature is to sell, bank a profit (which in this case is still substantial even after the pronounced drop in the share price) and recycle the capital. A 36 per cent stake is an uncomfortably large overhang and is almost certainly going to be causing a drag on the stock. More importantly it is likely to act as a drag on any re-rating that might be led by any future, sector-wide bounce or rebound: any strength in the share price risks leading to overhanging shares being sold with a piecemeal sell down being the worst outcome for the share price.

Conclusions

This is a hard investment story to call as there are too many key variables that are tough to call and there is plenty of risk despite recent trading being very robust. Management looks to be doing an excellent job in improving control of sales, looking to manage costs and pushing the brand harder into less mature markets. However, what it cannot control is how pressure on consumers will blunt its own efforts to forge ahead and into those headwinds what it can do to sustain its margins in the face of growing costs.

For the next year, everything looks to be under control and, assuming no major retail collapse in the back end of 2022, DM looks likely to hit expectations. For 2024 there is less certainty but analysts still seem to feel confident that internal momentum will be able to overcome market headwind. Even if growth is moderate in that year, it is still likely to be a lot better than we will see from much of the competition. At this stage it does feel as if forecasts for 2024 and 2025 are likely to be lowered although we suspect that growth can be sustained, just at a slower rate. This is not well-reflected in the rating. Overlaying this is the additional risk that as a fashion brand its star could begin to fade at any point for almost any reason driven more by cultural or social pressure more than economic.

The shares have perked up from a low point of 183p in May and rallied by almost close to 100p or nearly 50 per cent, but have now begun to lose some ground. On the current consensus forecasts the shares still look cheap with a PE dropping to less than 10x by March 2025 (12.5x this year and 11.3x next) but the consensus is probably too high. That said, the market looks to be prepared to pay only a slightly lower rating for next to no growth at large retailers like Next and much more for other footwear brands such as Nike (32x PE on recently trimmed forecasts) or Addias (21x PE on stable estimates) but both currently offer higher growth rates and feel far less prone to swings in fashion. Indeed, in a recession, sports footwear sales can rise as gyms are abandoned in favour of road miles.

The problem here is that the time to buy has largely been missed – that was in May when the shares were trading on barely 9x PE for the current year and only 7x to 2025. The rating today is undemanding but not especially cheap given the market climate, already well-known headwinds and the inherent risk in a fast rising fashion brand. Then there is the risk from the overhanging shares – if there was a well-managed exit especially if well spread over time, there should be no problem but private equity investors are always in a hurry and when the shares have begun to charge ahead, their attention is piqued.

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