

Alpha Shares Analysis

8 September 2023

Time to deliver on growth strategies

Our companies this week are both well known and trusted brands in the markets in which they operate. Both have growth opportunities but have challenges to overcome in growing their businesses. Much depends on the respective management teams' ability to deliver on strategies for growth. If they do so then, given neither stock looks super expensive, investors have scope to make decent returns.

Analyst: Phil Oakley

Sage Group (SGE)



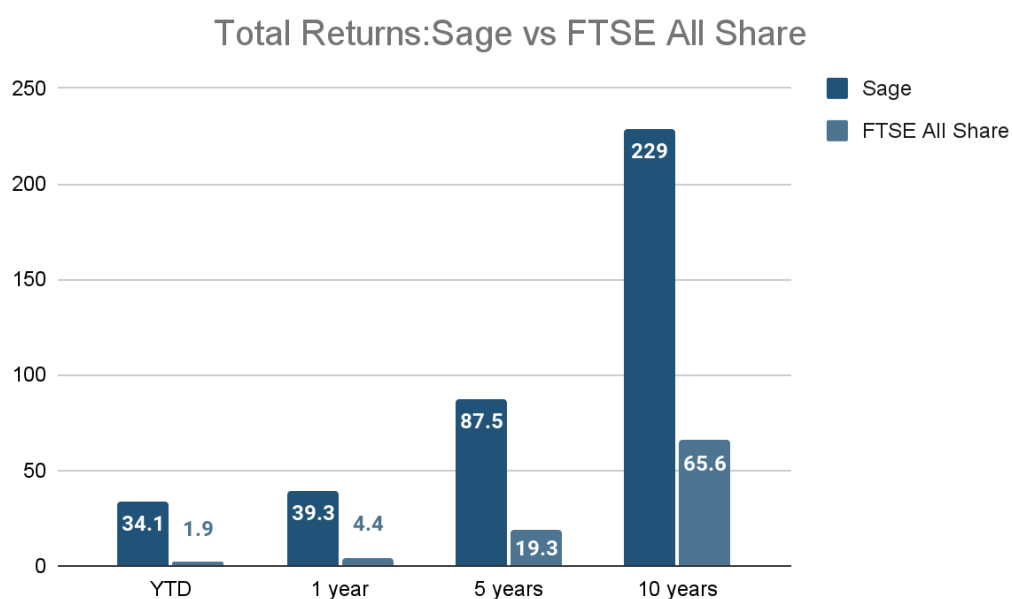
Source: LSEG

After being stuck in a range for some time, 2023 has been a very good year for **Sage (SGE)** shares. Can they sustain their momentum going forward?

Sage shares have proven to be a good long-term investment and have comfortably beaten the returns from the FTSE All Share index over time.

It has not been all plain sailing for the company and its investors in recent times. For much of the past five years, the share price had been stuck in a trading range and has only moved sustainably higher over the last year.

Much of this can be attributed to the company's struggles to develop and execute a credible growth strategy which it now seems to be doing,



Source: SharePad

The business

Sage designs and sells accounting and business software to small and medium-sized companies. Its products and services aim to make its customers' companies more productive and efficient, whilst helping them to learn more about their businesses so that they are well placed to grow their future profits.

Sage's portfolio of software helps companies and accountants perform a range of tasks such as accounting, invoicing, VAT calculations, corporation tax, stock control, payments and payroll. More sophisticated products help in areas such as business and financial management which provide detailed business intelligence reports.

For years Sage software products were bought in physical form (such as a disk) and installed on desktop computers. They became deeply entrenched within businesses and with lots of accounting firms.

The key to Sage's ongoing strategy is to move existing customers and get new ones onto its Business Cloud, which is based around the following core set of products:

- Sage Accounting – this allows companies to manage invoices and expenses and their tax compliance. They can share their data with an accountant or bookkeeper with the benefit that all the required data is in one place.
- Sage Payroll – an online payroll system that helps businesses to pay their workers.
- Sage Intacct – this is a comprehensive financial management system aimed at larger companies that have more complex financial and business management performance issues. It automates many processes which saves lots of time whilst providing value added business and financial analysis.
- Sage People – human resources and people management.
- Sage X3 – business management aimed at saving companies money by improving areas such as supply chains and staff costs

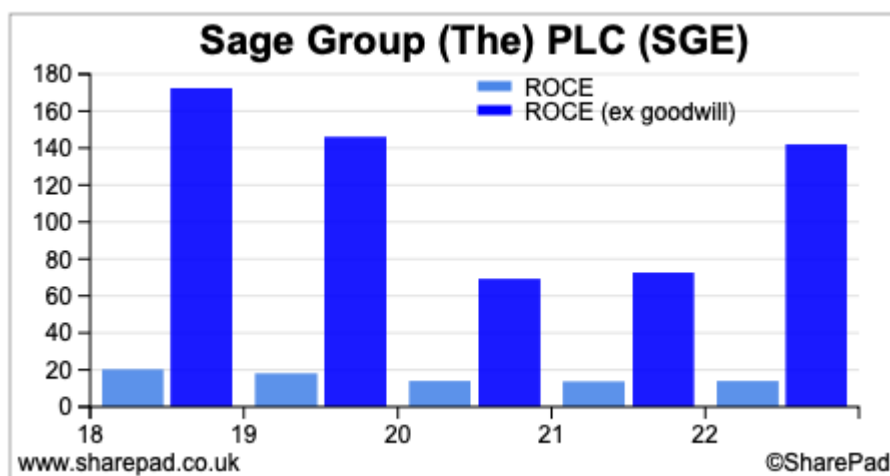
These products are complemented by many third party applications (apps) which allow Sage to offer better and more bespoke products. For example, Microsoft 365 is integrated into some of its products, whilst payment enablers such as PayPal can be attached to invoices so that companies can get paid faster.

Sage offers bespoke products for businesses. Sage 50 is its entry level product sold to small companies with up to 50 employees. It allows the customer to do all its necessary accounting tasks as well as things such as digital tax returns and stock control. Sage 200 is sold to bigger, growing companies and offers more analysis and management tools on top.

Highly profitable business

Like many software companies, Sage is a very profitable business. Excluding the goodwill paid on acquisitions, its return on operating capital (ROOCE) is comfortably over 100 per cent, which is a very impressive number.

Including goodwill, the ROCE was still a respectable 14 per cent in 2022.



One way in which investors look at software as a service (SaaS) companies is something known as the rule of 40.

The rule of 40 is simply the current rate of annualised recurring revenue growth plus the current operating margin. If the two sum to more than 40 then a company is doing very well.

Sage with current ARR growth of 10 per cent and margins of around 20 per cent has a score of just over 30. Very good SaaS businesses score 40 or more via a combination of strong growth and high operating margins.

Intuit (US:INTU), one of Sage's biggest rivals, would see its small business division – which includes Quickbooks accounting software – comfortably meet the rule of 40 on its current rates of profitability and growth. Fast growing **Xero (AU:XRO)**, which has lower margins would also come close to meeting it too.

Sage is underperforming its rivals on this measure, particularly when it comes to growth.

High levels of resilience

Financial and accounting software tends to be a very resilient business and isn't impacted too much by a downturn in an economy. Sage has confirmed as much in its last trading update in July.

The main reason for this is that the software is an essential tool for most companies in running their business. They cannot get by without it.

Revenues also tend to be very sticky as once a customer has become familiar with the software they usually stick with it. The costs and hassle of switching software systems is rarely worth it for many companies.

Strong position in the UK, but competition is intense

Sage does have some significant competitive strengths.

It has been around since 1982 and has become a trusted brand that is deeply entrenched within businesses and with firms of accountants, particularly in the UK.

When Sage has fared less well in recent years has been in winning a decent share of new business growth and the growth in cloud computing software.

However, Sage has been competing well and has built up a good reputation for customer service. It has introduced internet chat apps but also has extensive telephone support for its customers and provides lots of training as well.

This allows it to form a strong bond with the customer that is hard for a new entrant to copy. Good retention rates - typically around 100 per cent of contract values – is evidence of customer satisfaction.

Having said that, barriers to entry – particularly at the simpler end of the market – are not particularly high and there is a growing intensity of competition and consumer choice.

For small and medium-sized businesses, there is plenty of choice when it comes to accounting and finance software. The following companies are examples of some of the choices on offer in the UK as an alternative to Sage:

- FreeAgent
- Kashflow
- Quickbooks (Intuit)
- Xero
- Zoho Books
- FreshBooks

Both in the UK and the all important US market, Sage has been losing out to Intuit Quickbooks and Xero, which have been growing faster.

Intuit is making big investments in artificial intelligence (AI) and has a very clear marketing message – getting Quickbooks to do the work for you.

It is developing an ecosystem to cross sell Quickbooks with other products such as Mailchimp in order to drive growth. Intuit reckons that its small business division can achieve medium-term annual revenue growth rates of 15-20 per cent a year going forward.

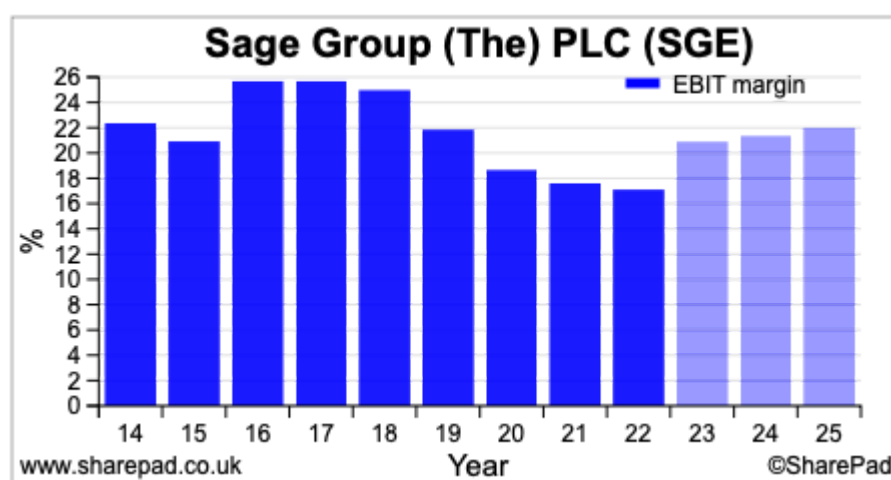
Xero is the big threat to Sage in the UK and is still a very small business in the US where it is intensifying its growth efforts. Xero's UK revenue growth was 27 per cent in the year to March 2023 as it has been very successful at winning new customers.

Xero's key strength is that its software has a reputation of being very easy to use and learn - something which may not be the case with Sage and other competitor products.

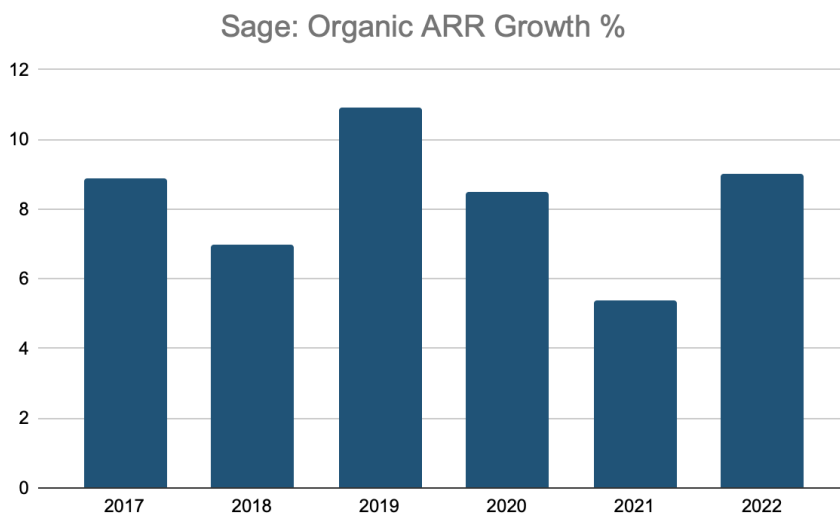
Sacrificing margins to accelerate growth

Sage's move to a subscription and cloud based business has come at a cost. It was behind its competitors in migrating customers to the cloud and has had to spend a lot of money to get itself into a position to compete and grow.

This has seen its profit margins decline significantly in recent times but they are expected to start rising again over the next few years.



The company attracted a lot of criticism for sacrificing its short term profit margins back in 2021, but the growth in annual recurring revenue (ARR) has been picking up, which is encouraging.

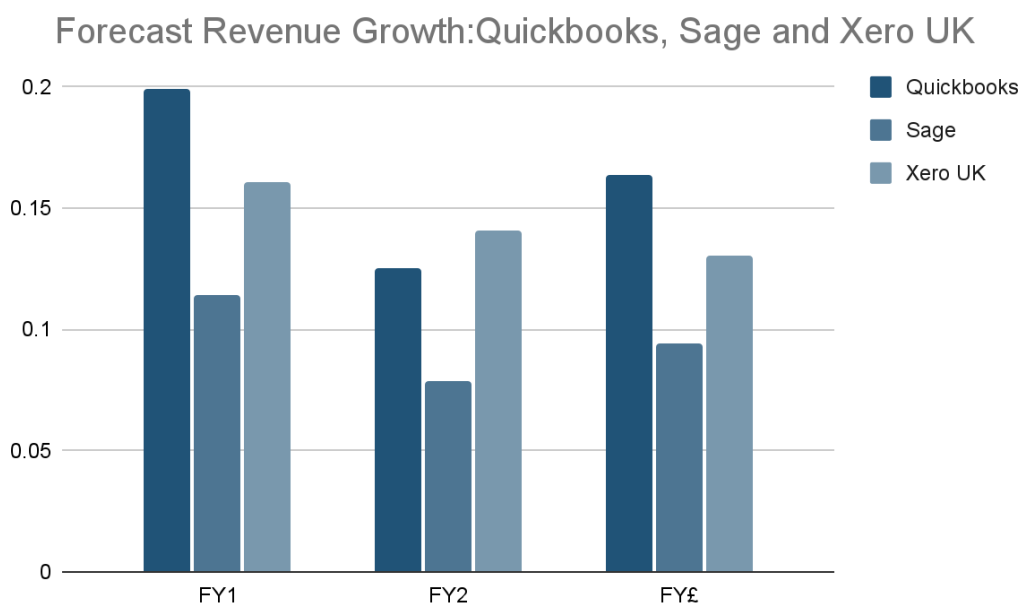


Source: Sage

Seventy nine per cent of Sage's customers are now on business cloud. This compares to just 18 per cent back in 2018. The company is now at a similar level of cloud penetration to Quickbooks which is a testimony to the efforts it has made in this area.

Lots of reasons to be bullish about Sage's growth prospects

Despite not growing as fast as its two main rivals, Sage is still well placed to deliver decent growth in its profits.



Source: FactSet

The shift to cloud computing is a long-term trend that has plenty of legs. Cloud penetration in the US, for example, is still very low.

When combined with the continued digitisation of accounting software, payroll, HR and back office functions, the outlook for Sage's future growth is promising.

UK legislation such as 'making tax digital' has fuelled growth in accounting software as all VAT registered businesses have to file their tax returns online.

From April 2026, landlords and self-employed individuals will also have to file their tax returns online if their annual income is more than £50,000. This limit will reduce to £30,000 from April 2027.

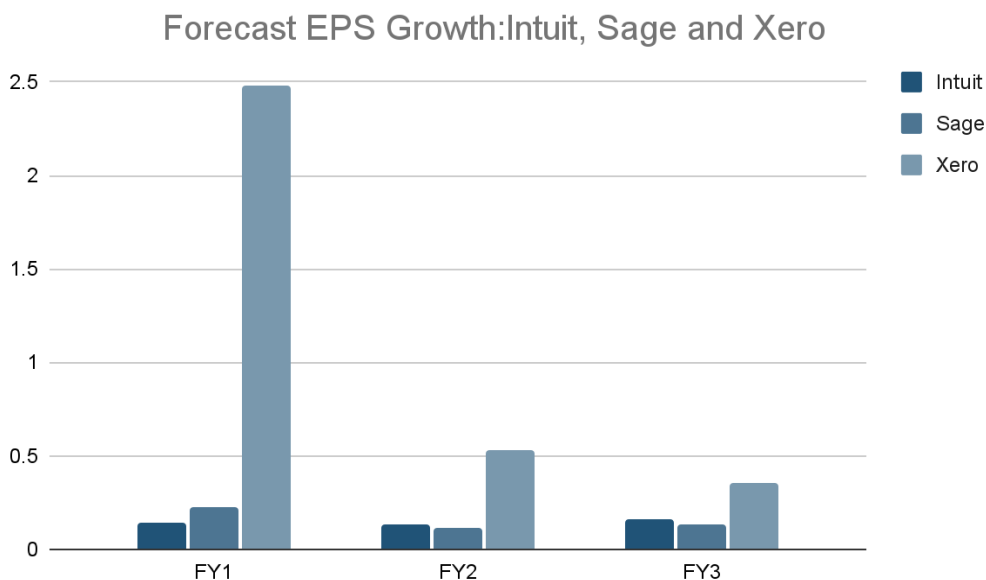
In terms of Sage's individual prospects, it has a great product in Sage Intacct. The financial management software has been a great success in the US where its revenues are still growing strongly.

However, it has barely been rolled out in other markets and has great potential to deliver good growth for Sage.

Another strong growth driver is artificial intelligence. Sage is embedding AI into its products to increase their productivity potential to help its customers become even more efficient.

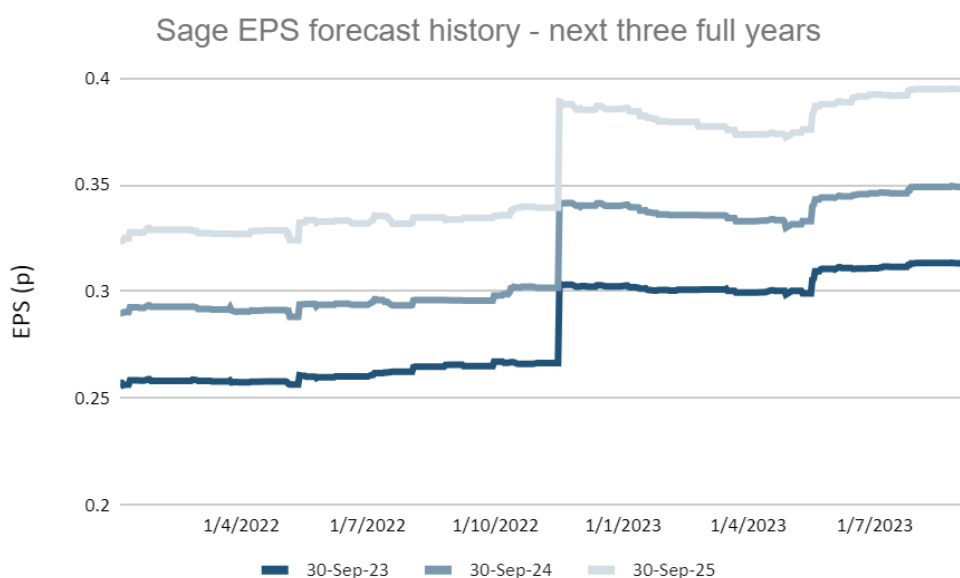
Whilst Sage is not expected to grow its earnings as fast as Intuit or Xero, its earnings per share growth forecasts- in the low double digit percentages – for the next few years look very healthy.

Continued below



Source: FactSet

Whilst Sage did not upgrade its full-year profit guidance back in July, consensus EPS estimates have been stable for the last few months.



Source: FactSet

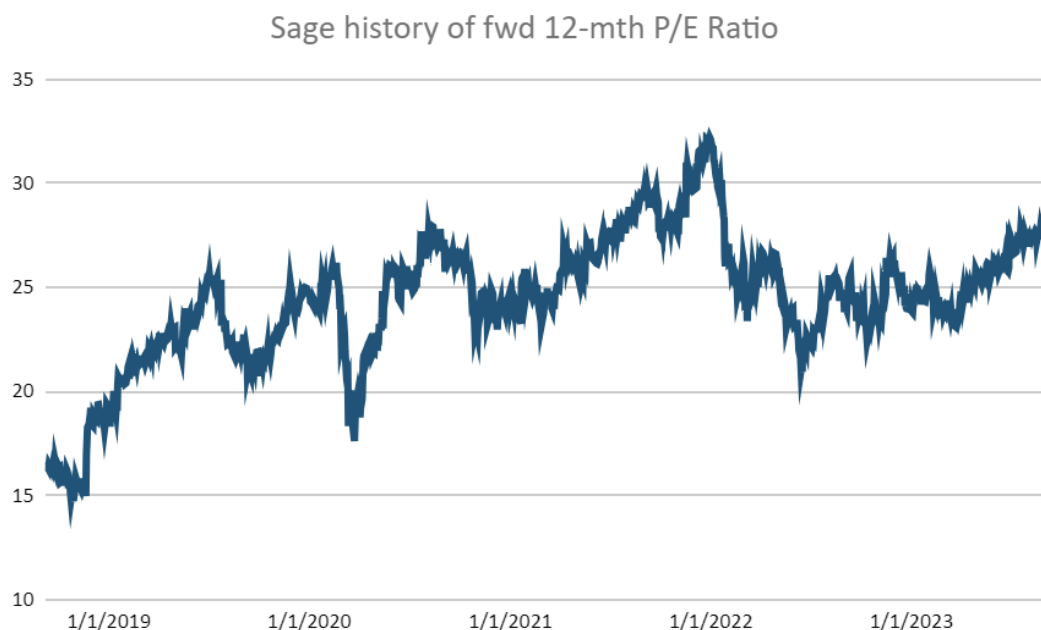
Valuation remains rich, but not excessive given high profitability and growth outlook

Sage is a very profitable and global software business which makes it something of a rarity on the London stock exchange.

SaaS companies tend to command high stock market valuations, especially if they are growing strongly. Growth tends to be very profitable, especially if it comes from subscriptions where the marginal cost of selling (excluding marketing) is practically nothing.

Sage shares have historically commanded a high PE multiple (the ratio of share price to earnings per share) based on forecasts of its next twelve months' EPS and that is still the case now.

The shares have been derated slightly over the last year due to higher interest rates which have dragged down the valuations of most highly-rated shares.



Source: FactSet

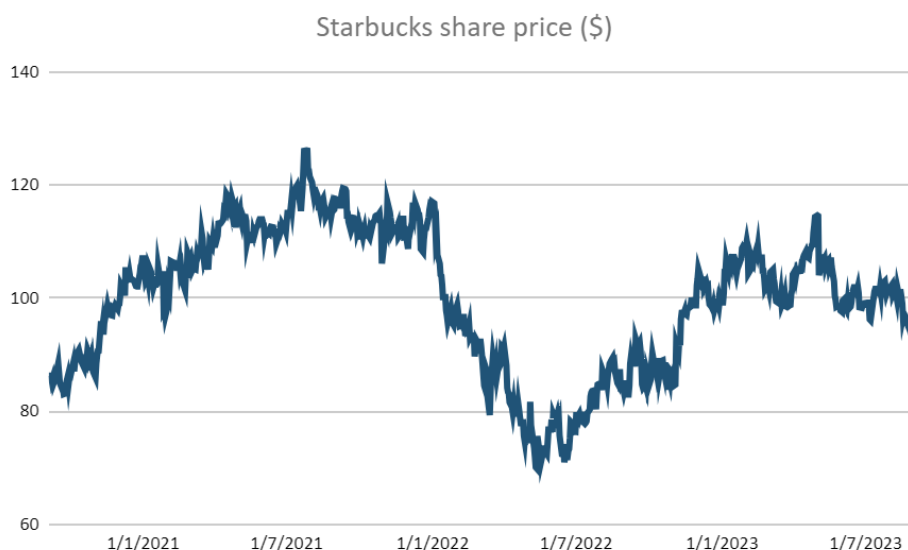
Due to its lower growth rate, it is not surprising to see Sage valued at a discount to Intuit and Xero. However, there is a case for saying that the shares could still offer value to a patient investor even after a very strong performance over the last year.

Sage: Valuation and Profitability compared with peers

Name	Ticker	EV/EBIT NTM (x)	P/E NTM (x)	ROCE (%)	EBIT Mgn NTM (%)	FCF Margin (%)
Sage Group	SGE-GB	22.1x	28.6x	15.0%	20.9%	15.0%
Intuit	INTU-US	25.2x	33.2x	13.1%	38.9%	33.9%
Xero	XRO-AU	72.9x	103.3x	3.9%	15.0%	27.4%

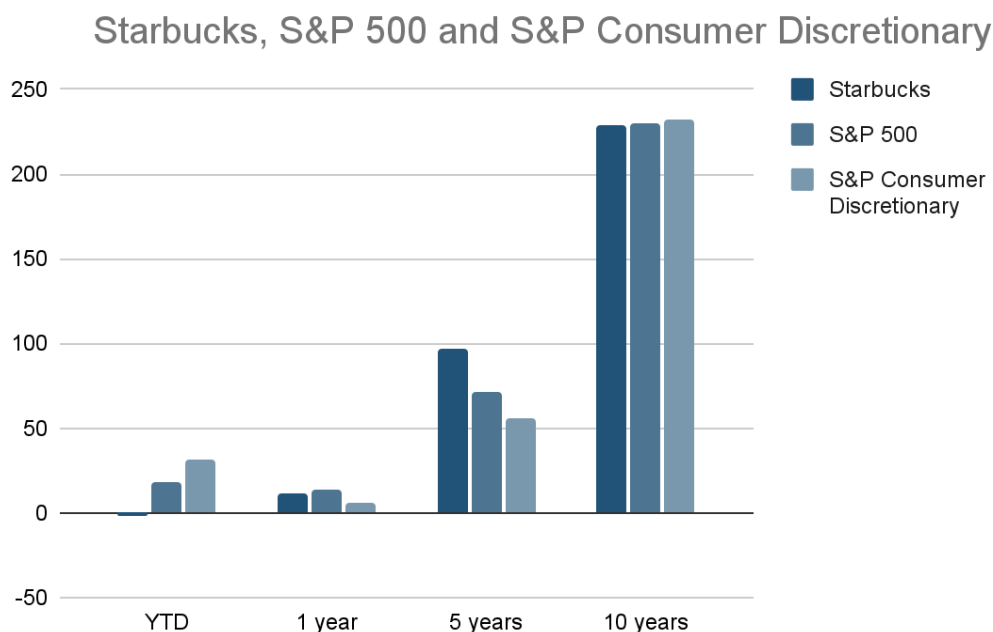
Source:FactSet

Starbucks (US:SBUX)



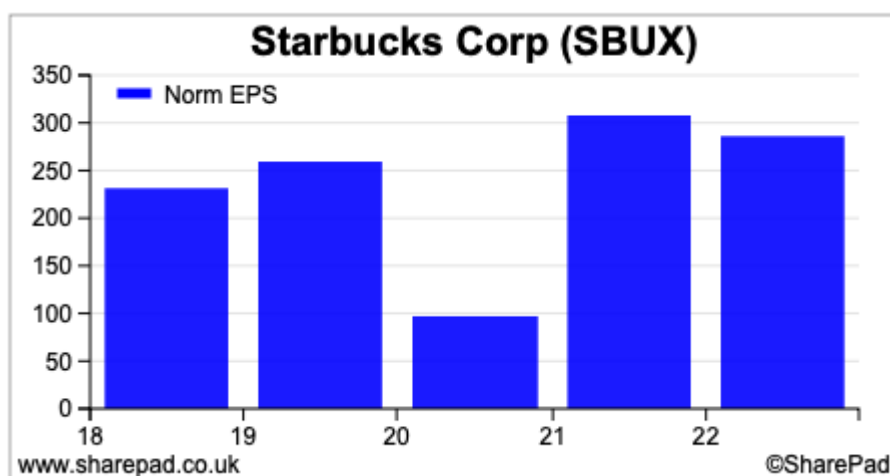
Source: LSEG

Coffee giant **Starbucks (US:SBUX)** has been a fairly solid long-term investment. Total returns from its shares over the last decade have matched those from the S&P 500 and the S&P consumer discretionary sector.



Source: FactSet

Short-term returns have been more disappointing with the shares significantly underperforming year to date. At the time of writing, the share price is lower than it was four years ago as profit growth (measured by EPS) has struggled to make much progress. This is largely due to the prolonged hit from Covid-19, especially in China.



The business

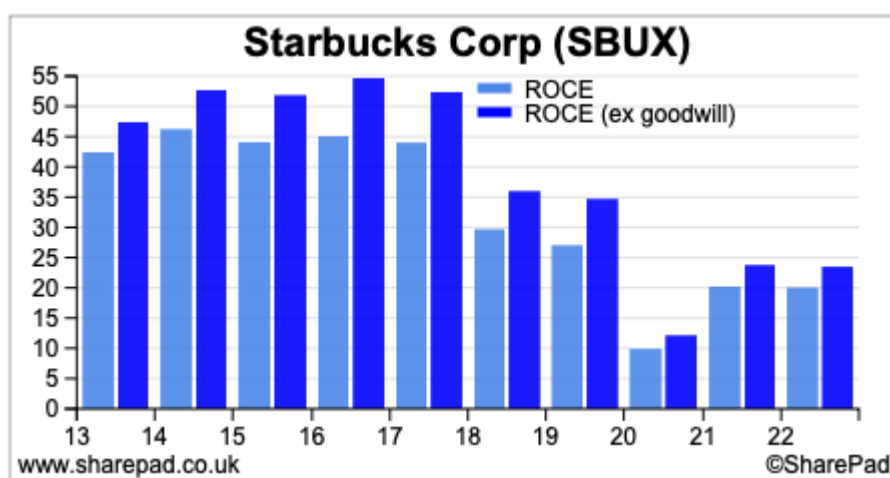
Starbucks is one of the most recognised coffee brands in the world. It operates from a global network of 37,222 stores, of which 51 per cent are owned by the company with 49 per cent being franchised.

The store network is dominated by the US which has 16,144 outlets followed by China with 6,480.

As well as coffee and beverages, the company sells food in its stores. It also sells coffee and ready to drink products through a wholesale channel to places such as supermarkets and over the internet.

Starbucks has more than 100 million customer orders per week and currently operates in 86 markets.

The business has been supremely profitable as measured by ROCE and ROOCE, but returns have come down recently. They are still at levels which would be considered to be the hallmark of a very good business.



How is Starbucks going to grow?

Starbucks, under its new chief executive, Laxman Narasimhan has put forward some very bullish medium term growth targets for the company. This is known as the reinvention plan. If it works then Starbucks will be expected to deliver the following levels of growth:

- 7-9 per cent same store sales
- 10- 12 per cent total revenue
- 15-20 per cent earnings per share.

To achieve this, it is going to have to get a lot of things right and arguably have a little bit of good fortune on its side as well.

People with a bearish view of Starbucks shares would point to the very ambitious same store sales growth target. In its core US market during the third quarter to June 2023, transaction volumes only increased by 1 per cent with the remainder of the 7 per cent growth coming from prices.

If it is going to achieve high levels of prolonged same store sales growth, Starbucks is going to probably have to get more customers through its doors and get them to buy more when they are in store.

It's not just about customers buying more but also getting them to buy more expensive and richer margin products.

There are grounds for optimism here given the growth in customised sales and sales of cold and frozen drinks. Starbucks is also selling more ready to drink products which typically have higher profit margins.

Sales volumes are also being driven up by more customers adding food to their orders.

Starbucks' loyalty card membership has grown by 80 per cent since 2019 and there are now over 31 million members. These customers tend to visit more often and spend more. The membership base also gives Starbucks a rich source of customer data from which to drive further sales growth.

The company also believes it can grow sales volumes by getting more sales outside peak breakfast and lunch time hours in the afternoon. Delivery sales are another opportunity and have already exceeded \$1bn.

Starbucks is very optimistic on its ability to open new stores, particularly in smaller US cities. It has also recently announced plans to open a further 100 stores in the UK.

These new stores are also moving to higher customer volume locations such as roadsides and drive throughs which now account for 15 per cent of Starbucks' total store count.

However, an undoubted source of revenue growth can come from the opening up and recovery of the Chinese market after Covid-19. This is already clearly seen in the company's recent third quarter results where China sales improved by 51 per cent.

Chinese stores that opened in 2019 or earlier have made a full sales recovery to pre Covid-19 levels. That said, there is still a lot of catching up to do with the newer stores.

Looking further out, Starbucks is confident that it can convince more Chinese people to drink more coffee which is no easy task in a nation of tea drinkers. US consumers on average drink just over one cup of coffee per day. In China it is currently around one cup per month.

No one expects Chinese consumers to end up drinking the same amount of coffee as Americans, but Starbucks points to Japan – another traditional tea drinking country – where the average coffee consumption per person is around four cups per week – as evidence of the growth potential.

In addition to the possible sources of revenue growth, Starbucks is making continued improvements in labour and in store productivity by investing in new equipment, which should help maintain and grow profit margins.

Margins should also get a boost from the leveraging of the fixed cost base from higher revenues.

While competition in the coffee market is fierce from rival coffee chains and the likes of **Mcdonald's (US:MCD)**, Starbucks believes it has competitive advantages in the form of the in-store experience, the quality of its coffee and product development.

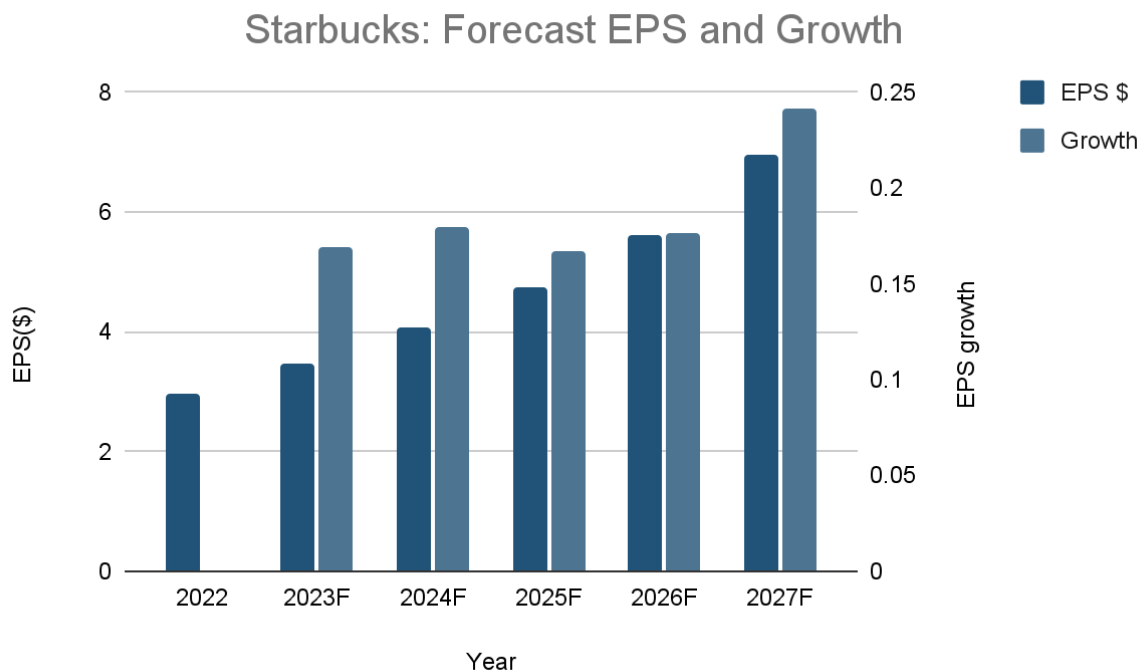
It is not unusual for a new CEO to put a positive spin on the prospects under their watch. That said, Laxman Narasimhans three year stint at **Reckitt Benckiser (RKT)** did not do much for shareholders as total returns were just 1.6 per cent during that time.

There are also concerns about worker unrest and increased unionisation at Starbucks. The company has historically eschewed unions and offered higher pay and benefits to keep them at bay.

Whilst there have been reports of unhappy staff, there is currently no expectation that Starbucks' margins are going to come down due to higher staff costs, despite a tight labour market.

Wall Street analysts buy in to growth targets

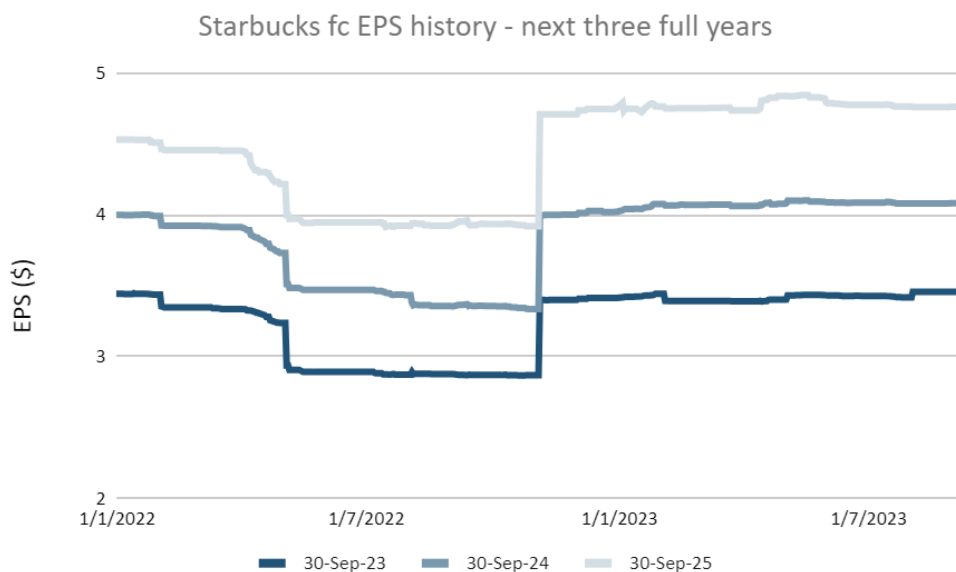
Starbucks' growth targets may be ambitious but Wall Street analysts currently believe they will be met based on current consensus forecasts.



Source: FactSet/Investors' Chronicle

Sentiment on this issue has improved given the upgraded full-year EPS guidance at the Q3 results at the beginning of August from 15 per cent to 16-17 per cent.

Forecasts for future years have also been moving up.

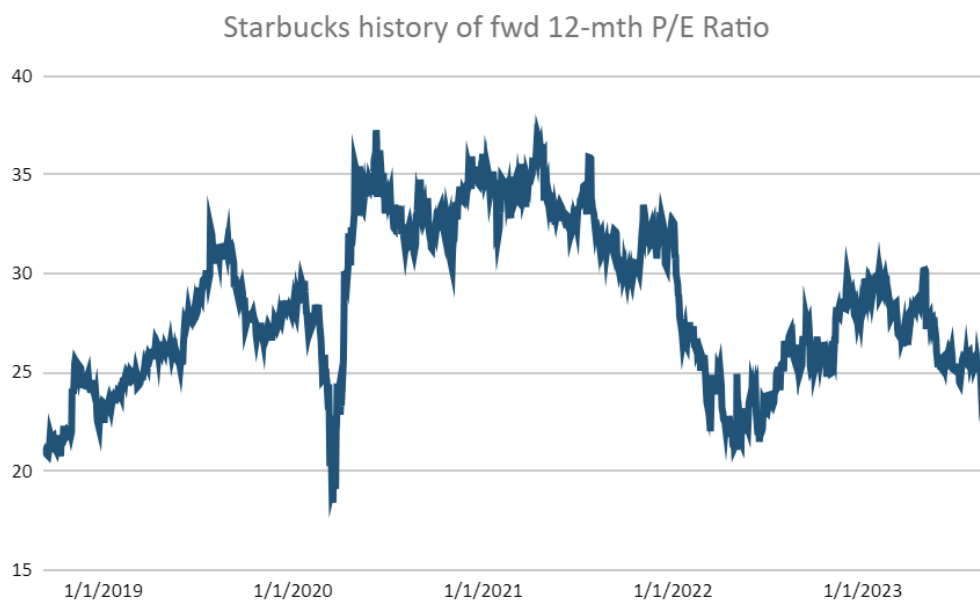


Source: FactSet

Starbucks shares look reasonable value if forecasts can be met

For the potential of high teens EPS growth, the current valuation of 23.7 times its next 12 months EPS doesn't look overly expensive.

If you also look at the shares' history on this measure, then Starbucks is trading at the lower end of historic range.



Source: FactSet

When compared with the valuation of restaurant shares, Starbucks is trading at levels comparable with many of its peers.

Starbucks: valuation vs peers

TIDM	Company	Market Cap (mn)	Price	PE roll 1	fc EV / EBIT	fc EV / EBITDA	fc EV / turnover	Yield roll 1	fc FCF yield
MCD	McDonalds	202,447	27785	22.6	19.9	17	9.2	2.3	4
SBUX	Starbucks	109,214	9535	23.7	21.4	17.2	3.4	2.4	3.1
CMG	Chipotle Mexican Grill	53,366	193636	39.4	34.6	28.6	5.4		2.4
YUM	YUM Brands	35,368	12623	22.2	19.7	18.5	6.5	1.9	4.2
DRI	Darden Restaurants	18,100	14981	16.5	14.2	10.7	1.6	3.6	5.8
DPZ	Domino's Pizza	13,628	38814	25.5	22.4	20.4	4.1	1.3	3.8
BROS	Dutch Bros	1,541	2653	123.7	72.7	15.1	2.2		

Source: SharePad

Those that worry about a US recession may question the current forecasts for Starbucks. That's fair enough. However, regular coffee purchases seem to have become the norm rather than a luxury or one-off treat. The business may end up being quite resilient - more so than some people think – unless there is a huge increase in unemployment and office layoffs.

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