



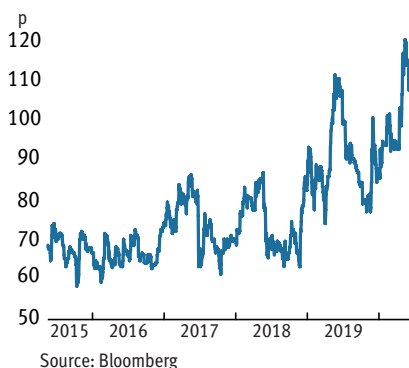
## Sanderson: Capitalising on the digital revolution

*The highly profitable software company is ideally placed to gain from increased adoption of technology by its core clients in manufacturing, supply chain logistics, wholesale and retail industries*

### Sanderson (SND)

|                         |   |
|-------------------------|---|
| Ticker                  | SND                                     |
| Current offer price (p) | 120                                     |
| Target price (p)        | 175                                     |
| Market cap (£m)         | 72.6                                    |
| 52-week high (p)        | 125                                     |
| 52-week low (p)         | 74                                      |
| Net cash (£m)           | £2.9m (reported at 31 Mar 2019)         |
| Shares in issue (m)     | 60.47                                   |
| Financial year-end      | 30 Sep                                  |
| Next event              | Pre-closing trading update mid-Oct 2019 |
| Company website         | sanderson.com                           |

### Sanderson's share price



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### Simon Thompson's view:

It's not difficult to understand why Sanderson's proprietary product suite is in such high demand from the 800 small and medium-sized businesses that license it. Not only does the technology deliver value for money, it offers tangible business benefits that allow corporate customers to gain a competitive advantage in marketing, sales and logistics. It's a win-win situation, and one that is being materially undervalued by investors with the shares trading on a modest 12 times cash-adjusted earnings estimates for the 2020 financial year – a chunky discount to peers.

### Bull points

- High recurring contracted revenue stream.
- Around 90 per cent of revenues from long-term relationships.
- High gross margins from proprietary software.
- Strong order book.
- High cash generation of operating profit into operating cash flow.
- Cash rich balance sheet and access to low-cost finance facilities.
- Cash generation recycled into progressive dividend, bolt-on acquisitions and investment in new products to drive growth.
- Product suite creates efficiency savings for clients.
- Focus on digital technology offers competitive advantage.
- Regulatory compliance requirements for customers supportive of positive order flows.
- Full benefits of acquisitions to be seen in 2019/20 financial year.
- Board conservative in guidance, so record of 'under promising' and 'over delivering'.
- Potential takeover target.
- Secondary placing of part of chairman's stake has improved liquidity and widened shareholder base.
- Lowly rated on peer group basis.

### Bear points

- Brexit uncertainty.
- Pension liability.
- Execution risk integrating acquisitions.
- Potential for order deferrals in economic downturn.

This is shaping up as a vintage year for Coventry-based **Sanderson Group (Aim:SND)**, a highly profitable and well-established software company that first listed on London's junior market in December 2004. The business was founded in 1983 and now specialises in the retail, wholesale, supply chain logistics, food and drink processing and manufacturing sectors.

Employing a workforce of 315, the company's cutting-edge proprietary software is sold to over 800 small- and medium-sized enterprises (SMEs) in the UK, and is specifically designed in anticipation of technological developments, often in conjunction and collaboration with customers. Importantly, the product suite delivers value for money, with cost-effective, timely and tangible business benefits that allow customers to gain a competitive advantage, thus enabling them to grow sales, while also achieving improved productivity, additional efficiencies and cost savings. Sanderson customers usually achieve rapid return on their investment (often within a year of implementation). Productivity improvements and cost savings are key drivers of customers' investments, one reason why Sanderson is faring so well, despite UK economic uncertainty and challenging trading conditions in the retail sector.

Indeed, half-year results released last month for the six months to end-March 2019 revealed strong trading across both of Sanderson's businesses (digital retail and enterprise solutions), with both divisions posting double-digit growth in revenue and operating profit. Understanding how advances in technology are changing consumers and businesses behavioural patterns, and providing its customers with solutions that address these issues, is key to Sanderson's success.

### Sanderson (SND)

**Ord Price:** 120p **Market Value:** £72.6m

**Touch:** 118-122p **12-Month High:** 125p **Low:** 74p

**Dividend Yield:** 2.5% **PE Ratio:** 13

**Net Asset Value\*:** 56p **Net Cash:** £2.8m

| Year to<br>30 Sep | Revenue<br>(£m) | Pre-tax<br>profit (£m) | Diluted earnings<br>per share (p) | Dividend<br>per share (p) |
|-------------------|-----------------|------------------------|-----------------------------------|---------------------------|
| 2013              | 13.8            | 2.19                   | 4.20                              | 1.20                      |
| 2014              | 16.4            | 2.71                   | 4.40                              | 1.50                      |
| 2015              | 19.2            | 2.91                   | 4.90                              | 2.10                      |
| 2016              | 21.3            | 3.44                   | 5.50                              | 2.40                      |
| 2017              | 21.6            | 3.73                   | 6.30                              | 2.65                      |
| 2018              | 32.1            | 4.85                   | 7.60                              | 3.00                      |
| 2019**            | 35.3            | 5.40                   | 8.10                              | 3.40                      |
| 2020**            | 39.0            | 6.00                   | 9.10                              | 3.60                      |
| % change          | 10%             | 11%                    | 12%                               | –                         |

Normal market size: 3,000 SETSqx

\*Includes intangibles assets of £42.7m, or 71p a share

\*\* WH Ireland estimates. Pre-tax profits and EPS stated before amortisation of intangibles assets, share-based payments and one-off non-recurring items. EPS stated on a fully diluted basis.

Source: Sanderson annual report, London Stock Exchange

*“We can see every customer’s history throughout the organisation, whether they bought via the web, store or by mail order – it’s all there”*

– OKA, multi-channel retailer of premium furniture and home accessories

*“Sanderson Group’s One iota software solution has proved to be the ideal partner for us – developing and implementing a fantastic in-store iPad solution which fully integrates with our existing business systems”*

– Superdry

Online shopping is easy and convenient. Open 24 hours a day seven days a week, the customer can shop anywhere, anytime. Internet retailers can offer great discounts, flash sales, and use the data they hold to market to customers, personalise communication and meet their needs at the right time. But there still remains a place for the high street; consumers still love to browse and the majority of retail sales are still store-based. Therefore, it’s critical for retailers to bridge the gap between online and in-store to offer a seamless, joined-up shopping experience which their customers now demand.

Retailers who fail to provide their customers with a fully connected shopping experience risk missing out on sales opportunities and the chance to create a retail experience where shoppers want to spend time and money. Those who do bridge the gap and utilise in-store technology, such as transactional kiosks and assisted-selling tablets, can sell beyond what is simply ‘on the shelf’. They can showcase their entire range, upsell, and avoid lost sales by allowing customers to order out-of-stock items for next day delivery, or use home delivery so customers don’t have to carry heavy bags around. Sanderson’s research shows that retailers embracing digital in-store technology solutions benefit from sales uplifts of up to 10 per cent within their stores.

As a long-standing supplier of software and services to retail, mail order, catalogue, fulfilment, wholesale and online businesses, Sanderson has a unique understanding of omni-channel sales and is able to offer a comprehensive range of IT solutions to meet the changing needs of organisations in the retail industry.

For instance, the company’s One iota business, which was acquired six years ago, is at the forefront of retail technology, working with many of the UK’s leading retail brands, including John Lewis and Superdry, to create and implement an exceptional shopping experience using online, in-store and interactive solutions.

Sanderson provides integrated in-store technology; the back-office systems which are so crucial to processing sales and fulfilling customer orders efficiently; and mobile and ecommerce systems which underpin online operations. These solutions are operated from One iota’s cloud-based platform, MESH, allowing retailers to cost-effectively extend their existing ecommerce capabilities across any device or sales channel, including mobile web and apps; in-store till (EPoS) apps; assisted selling tablets; mobile payments such as Apple and Android Pay; interactive digital signage; and beacon technology which allows retailers to communicate with customers’ mobile devices for marketing purposes, thus providing them timely and relevant content to increase their loyalty and build brand

## Sanderson's Digital Retail operating margins improving



Source: Sanderson annual report

*“We were able to double sales volumes with Elucid, with no performance issues whatsoever. Our ecommerce sales increased 100 per cent to over £20m within two years of working with Sanderson”*

– Topgrade Sportswear and Getthelabel.com

engagement. This is not just high tech proprietary software, it is high margin, which is why Sanderson boasts a retail gross margin of 75 per cent on sales.

### Sanderson's Digital Retail operating margins improving

| Year ended 30 Sep       | 2015   | 2016   | 2017   | 2018   |
|-------------------------|--------|--------|--------|--------|
| Revenue                 | £5.87m | £6.39m | £7.28m | £8.82m |
| Gross profit            | £5.16m | £5.30m | £5.56m | £6.62m |
| Gross profit margin     | 87.9%  | 82.9%  | 76.4%  | 75.1%  |
| Operating profit*       | £1.29m | £0.89m | £1.18m | £1.56m |
| Operating profit margin | 22.0%  | 13.9%  | 16.3%  | 17.6%  |

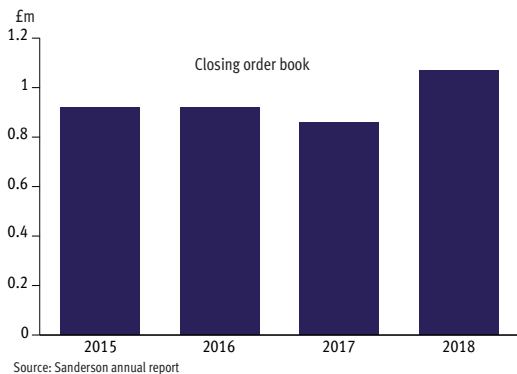
\* Operating profit declined in 2016 after £500,000 planned investment in management, sales, and delivery capacity in anticipation of rapid growth within digital retail market.  
Source: Sanderson annual report

It's not the only smart retail product the company offers either. Sanderson's Elucid multi-channel retail software is used by over 50 UK-based multi-channel and high street retailers. Elucid provides all the functionality clients need by integrating their ecommerce, mobile commerce, marketplace (many customers are deploying Amazon, eBay, La Redoute and Zolanda ecommerce marketplaces), retail and mail order sales with back office fulfilment operations. This helps to improve service to end customers, which boosts profitability and underpins business growth. With unlimited users and unlimited brands sharing the same back office system, and offering the capability to process tens of thousands of orders each day, the Elucid product is growing traction.

This is hardly surprising given that research from Deloitte shows customers who shop across multiple channels spend an average of 82 per cent more on each transaction compared with single-channel shoppers. So, there is a significant sales incentive for retailers to adopt a multi-channel offering to tap into the 78 per cent of all retail customers who are using at least two channels when they make a purchase. These customers typically start with a company's website before heading to the local store to check out products. Often they then go back online to compare prices and make their purchase. Elucid allows retailers to cater for all types of popular buying behaviour.

Sanderson has developed new products, too, including Elucid 'ship from store' and 'click and collect' software, which enables retailers to offer their customers a 'buy anywhere, deliver anywhere, return anywhere' proposition. There are compelling benefits for retailers adopting the solution as they can increase revenue by capturing potential lost sales; boost profitability with less discounting; unlock cash previously tied up in stock, thus improving working capital management and stock turn; and enhance the customer shopping experience and satisfaction levels while at the same time improving store footfall and potential upselling opportunities.

### Sanderson Digital Retail closing order book on the rise



### New digital retail clients boost recurring revenue

New retail customer wins in the latest six-month trading period include an order with formal-wear retailer, Hawes & Curtis, and large sales orders from Richer Sounds, David Austin Roses, and Office Holdings. Interestingly, the Hawes & Curtis contract followed a successful pilot scheme, as was the case with a phase one order from iconic global brand, Hugo Boss, in the 2018 financial year. This highlights the opportunity to convert Sanderson’s sales pipeline into confirmed contracts.

New order flow is important given that Sanderson’s core revenue model is a “right to use” licence model which generates the following revenue streams:

- Initial licence fee which is dependent on the number of users and modules taken by the client.
- Annual licence fee charged at 15 per cent of the initial licence fee.
- Professional services revenue relating to implementation, charged on a time & materials basis – this is typically at least as much as the initial licence fee.
- Annual support and maintenance fee, charged at 5 per cent of the initial licence fee.

Contracts are typically annual, although some clients sign up for an extended initial period which can be up to five years.

### Sanderson Digital Retail order book on the rise

| Year ended 30 Sep  | 2015   | 2016   | 2017   | 2018   |
|--------------------|--------|--------|--------|--------|
| Closing order book | £0.92m | £0.92m | £0.86m | £1.07m |

Source: Sanderson annual report

Robust order intake in the 2018 financial year helped increase digital retail revenues by a fifth to £8.8m and lifted divisional operating profit by almost a third, to £1.55m. This accounted for 27 per cent of group revenue and 30 per cent of group operating profit in the 12-month trading period.

The progress was maintained in the first half (to end March 2019) when the division lifted revenue by 11 per cent to £6m and operating profit by 29 per cent to £1.2m. It’s notable that recurring revenue from this business edged up to 47 per cent of divisional total sales, highlighting the solid income from a loyal customer base. It’s not the only part of the business performing well.



## Enterprise division delivers strong operating profit growth



*“The Sanderson software paid for itself in the first eight weeks and has provided the platform for huge growth, from £8m to £26m”*

– Axminster Tools and Machinery, multi-channel supplier of industrial tools, consumables and machinery

## Enterprise solutions division

Around 72 per cent of Sanderson’s annual sales are generated from its Enterprise solutions division which comprises three market-focused businesses operating in the manufacturing, wholesale distribution and supply chain logistics sectors. Productivity gains, improved efficiency and cost savings are key end-user demand drivers in all three markets. All three businesses within the division are performing well, delivering a 33 per cent increase in operating profits to £3.6m in the 2018 financial year on revenues up 62 per cent to £23.2m, helped by a maiden contribution from the Anisa acquisition (see below) in late 2017. Divisional profits rose by 27 per cent in the first half of the current financial year, too.

### Enterprise division’s strong operating profit growth on high margin

| Year ended 30 Sep       | 2015    | 2016    | 2017    | 2018    |
|-------------------------|---------|---------|---------|---------|
| Revenue                 | £13.30m | £14.90m | £14.27m | £23.23m |
| Gross profit            | £11.06m | £12.17m | £12.62m | £18.90m |
| Gross profit margin     | 83.2%   | 81.7%   | 88.4%   | 81.4%   |
| Operating profit        | £2.01m  | £2.80m  | £2.71m  | £3.61m  |
| Operating profit margin | 15.1%   | 18.8%   | 19.0%   | 15.5%   |

Source: Sanderson annual report

## Enterprise Resource Planning manufacturing software

The main areas of specialisation for Sanderson’s Enterprise manufacturing business are in the engineering, plastics, aerospace, electronics, print, and food and drink processing sectors. The latter segment is where most of the activity is being driven.

Sanderson’s Enterprise Resource Planning (ERP) software and cloud-based solution is described by management as “the software of choice for the UK’s fast growing food and beverage producers”. This claim has a fair degree of substance, given that more than 140 customers deploy the software to improve their inventory usage, through the use of food optimised work management systems. These provide protection with class-leading quality and traceability controls of ingredients through the supply chain, and meet the need to comply with increasingly stringent regulatory standards.

It’s a growth industry too. That’s because food and drink processors are investing in technology to run their businesses more efficiently and manage the complexities of their tightly regulated industry. So, while some manufacturing sectors are more volatile and susceptible to economic uncertainty, the UK food sector has remained relatively recession proof. Although the industry is facing cost pressures, particularly following the EU referendum, there are efficiency gains and cost savings to be made

*“More than 120  
wholesale cash and  
carry businesses now  
use Sanderson’s  
specialist wholesale  
software, Swords”*

from implementing new systems which Sanderson is delivering. In the latest six-month trading period, Sanderson booked large orders from existing customers (Newly Weds Foods and Adelie Foods), highlighting the potential to grow its recurring revenue stream.

### **Wholesale distribution**

Wholesale distribution is a key area for Sanderson’s Enterprise division and is a vital sector too, linking manufacturers with all types of food and non-food retailers and foodservice businesses. The retail arena has developed sophisticated methods to attract sales, offer more shopping channels and retain customers through higher levels of service and increased convenience. The use of technology and data is increasing in the wholesale industry, too.

Wholesale businesses are reappraising the way their customers want to buy from them, and the use of technology is instrumental in achieving success in this area. Research from IGD, the global food and grocery experts, highlights that wholesalers adopting software technology have been delivering double-digit sales growth. More than 120 wholesale cash and carry businesses now use Sanderson’s specialist wholesale software, Swords. This streamlines and improves visibility of processes through integration of all business operations, from back office to delivery of customer orders. It also cuts costs from administrative overheads and improves customer service.

Sanderson has been exploiting the new technology opportunity here, too. Its business intelligence wholesale software enables customers to identify sales trends, and analyse and transform critical data (such as sales, purchasing, stock and cash) from systems into valuable business information. Dashboards presenting key financial information deliver a real-time overview of a company’s current performance – with the ability to drill down into the detail. The data can then be used to create targeted marketing campaigns to drive sales. Furthermore, the software has been developed to identify slow selling products, missed sales, and review supplier performance to help Sanderson’s customers negotiate better terms and prices. It can also easily identify how products, regions, sales and staff are performing, to help in making strategic decisions.

The company has also developed specialist warehouse management software for multi-channel retailers, specialist third party logistics providers, and fulfilment houses to cover the entire supply chain. It is designed to streamline warehouse operations and optimise inventory levels, offering customers full traceability of goods with automated processes and accurate up to the minute reporting to enable informed decision making. For instance, it can give

*“We have achieved a single stock vision, supported by a single supply chain, with transparency of prices, stock data, promotions and sales across all operations and channels”*

– JoJo Bébé, multi-channel retailer of maternity and babywear

a real-time picture of current workload for staff, enhance pick rates and reduce errors with automated picking routines, monitor performance, and optimise purchase options for inventory.

That’s not the only smart software that Sanderson has developed as last month the company reported “strong interest in a new innovative suite of digital solutions that enables customers to capitalise on the increased use of mobile devices by improving productivity and sales.”

### Enterprise division order book surges

| Year ended 30 Sep  | 2015   | 2016   | 2017   | 2018   |
|--------------------|--------|--------|--------|--------|
| Closing order book | £1.43m | £2.10m | £1.81m | £5.36m |

Source: Sanderson annual report

### Supply chain logistics

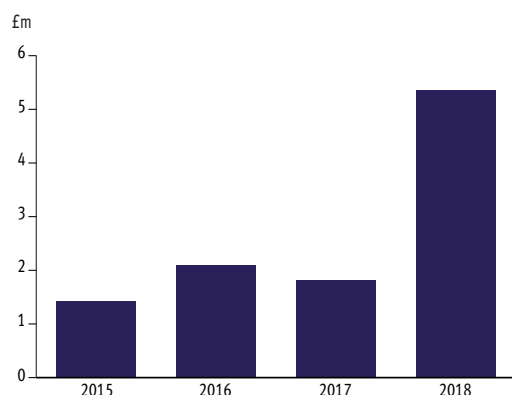
The logistics sector employs one in 12 people in the UK and contributes £91bn to the economy, with ecommerce and the complexity of modern supply chains driving growth. Fuelled by an increase in delivery options, together with a rise in orders due to mobile and online ordering, logistics is fast becoming ‘the new retail’. Technology is driving competitive advantage as retail activity shifts from shop to warehouse, with growth in fulfilment centres rather than stores. Three quarters of operators in the sector expect increased capital expenditure in IT to drive efficiency and productivity according to the latest findings of the UK Logistics Confidence Index (compiled by Barclays and Moore Stephens, in conjunction with specialist sector research agency Analytica).

Sanderson was strengthened in the autumn of 2017 by the £12m acquisition of Anisa, a specialist in delivery of integrated supply chain and enterprise resource planning (ERP) solutions. Sanderson’s Supply Chain Logistics software business now supplies leading organisations with warehouse or transport operations, delivering complete supply chain visibility and competitive advantage. The software is delivered as a cloud-based managed service or installed on premise to streamline complex distribution environments. Benefits include improved planning and management; faster, more efficient deliveries; reduced paperwork with electronic proof of delivery; improved vehicle efficiency and management; and enhanced customer service with real-time updates given on a track and trace portal. Sanderson’s management say businesses that work with the company win and retain more customers, grow quicker and are more profitable.

It will play a part in the UK’s supply network post Brexit as The Port of Dover, a vital international gateway for the movement of people and trade, has appointed Sanderson



## Enterprise division order book surges



Source: Sanderson annual report

to supply its Warehouse Management and Cargo Terminal Management software for the new Refrigerated Cargo Terminal (RCT) at the port. Sanderson software solutions will manage operations across the terminal including ships unloading at the quay and dispatch from warehouse to road, with live tracking of vehicle and container movements. The solution is set to make a huge difference to the business: growing revenue, boosting efficiencies and delivering service improvements.

It's not the only good news - Sanderson's Supply Chain Logistics business reported a raft of major order wins in the first half of the current financial year, including contracts with NHS Blood and Transplant, energy group Centrica, and Vivarail, a UK rolling stock manufacturer. The sales pipeline is described as "very strong and continued growth is expected in the second half."

## Strong first-half performance

Admittedly, the adoption of IFRS 15 accounting standards has somewhat distorted the first half trading performance of Sanderson. Operating profit surged by a third to £2.79m, on revenue up 18 per cent to £17.2m. Comparables were not restated for the prior half-year as the accounting standard has been adopted on a modified retrospective basis. However, on a comparable basis excluding the impact of IFRS15, revenue would still have risen by 16 per cent to £16.9m and operating profit was still up 20 per cent to £2.53m.

Key points to take away include a rock solid and eye-catching gross margin of 79 per cent, highlighting the pricing power of sales of Sanderson-owned proprietary software solutions. The company is focused on building up its pre-contracted recurring revenue stream, which has been boosted by the addition of revenue from its hosted managed solutions business. First half recurring revenue of £9.55m equated to 55 per cent of income earned in the six-month trading period, an important revenue stream that improves visibility of earnings as well as the multiple investors are prepared to value those earnings on.

Furthermore, the order book was £8.2m at the end of March after the company signed up 15 new clients in the first half. This supports analysts full-year predictions that point to pre-tax profit rising by 17 per cent to £5.4m to deliver fully diluted earnings per share (EPS) of 8.1p. A 20 per cent hike in the interim dividend per share to 1.5p (ex-dividend date of 4 July 2019) suggests that analysts' forecasts of a 13 per cent hike in the annual dividend from 3p to 3.4p are well founded, especially as Sanderson's board have doubled the payout per share in the past four financial years.

### Sanderson high conversion rates



Source: Sanderson annual report

### Sanderson's high cash conversion rates

|   | 2014  | 2015  | 2016  | 2017  | 2018  |
|---|-------|-------|-------|-------|-------|
| Operating profit                        | £2.8m | £3.3m | £3.7m | £3.9m | £5.2m |
| Net cash flow from operating activities | £2.3m | £2.4m | £3.6m | £4.5m | £5.3m |
| Cash conversion rate                    | 83%   | 73%   | 99%   | 115%  | 102%  |
| Closing net cash                        | £6.2m | £4.6m | £4.3m | £6.2m | £1.6m |

### ....enable bolt-on acquisitions from cash flow and progressive dividends

|                    | 2014  | 2015  | 2016  | 2017  | 2018  |
|--------------------|-------|-------|-------|-------|-------|
| Dividend per share | 1.50p | 2.10p | 2.40p | 2.65p | 3.00p |

Source: Sanderson annual report

It's worth noting that net funds of £2.8m at the end of March 2019, after accounting for finance leases, were ahead of management's guidance and had increased from £1.6m at the September 2019 financial year end. This highlights the highly cash generative nature of the business. In fact, net cash generated from operating activities was £3.26m in the first half – well ahead of operating profit of £2.79m in the same six-month period. This is not unusual, as Sanderson converts a high percentage of its operating profit into cash. For instance, in the 2018 financial year, net cash of £5.3m was generated from operating activities, well ahead of operating profit of £5.2m.

The bumper cash flow generation enables Sanderson's board to invest in new products, adopt a highly progressive dividend policy, and recycle surplus cash into bolt-on acquisitions. The company generated a post-tax return on average equity of almost 15 per cent in the 2018 financial year, so it clearly makes sense to recycle cash into business areas where it can enhance shareholders' returns. That's exactly what Sanderson's management have just done.

### Bolt-on acquisitions driving profitable growth too

In early May this year, Sanderson announced the complementary acquisition of Gould Hall, a provider of enterprise solutions to customers in the supply chain and distribution sectors. The initial consideration of £1.85m consists of cash of £1.27m and the issue to the vendor of 500,000 Sanderson shares, subject to a three-year lock in. Deferred consideration of £2.15m is payable over the next six years, of which only £600,000 is an unconditional payment and the balance is subject to performance targets being hit. Gould Hall had net funds of £790,000 at the time of the acquisition, so the maximum consideration of £3.17m represents a reasonable 10.5 times Gould Hall's pre-tax profit of £300,000 in the 2018 financial year.

Sanderson can easily afford to make this acquisition, and others too. That's because as of 31 March 2019, the compa-

ny's half-year end, Sanderson had gross cash of £6m, bank loans of £2.75m, loan notes of £258,000 and hire purchase debt of £267,000. The interest rate on the £4.1m term loan which was acquired as part of the Anisa acquisition, and which has been substantially paid down in the past 18 months, is 2.15 per cent above LIBOR, a highly competitive rate. Only £258,000 of the original £1.05m loan notes secured on the assets of Anisa are outstanding. It pays for Sanderson to recycle part of its growing gross cash pile into new acquisition opportunities while at the same time paying down the low-cost term loan from future cash flow as it enhances shareholder value.

### **Cash building**

Management guidance supports analysts' predictions that the company can lift 2019 pre-tax profits by 11 per cent to £5.4m. Plus, with the benefit of a full 12-month profit contribution from both Anisa and Gould Hall in the 2019/20 financial year, there is a possibility of Sanderson lifting pre-tax profit again. With this enhanced visibility, brokerage WH Ireland predict another 11 per cent increase to £6m, on revenue of £39m.

On this basis, the shares are rated on a modest 13 times 2020 fully diluted earnings per share (EPS) estimates of 9.1p. That's hardly a punchy valuation for a company that is generating a post-tax return on equity of 15 per cent and is producing annual net operating cash flow in excess of £5m. In fact, even after accounting for the Gould Hall acquisition, Sanderson should end the 2019 financial year with net funds north of £3m. Net cash could easily double to £6m by September 2020, a sum worth 10p a share. In other words, on a cash-adjusted basis, the shares are effectively priced on a price/earnings (PE) ratio of 12, a massive discount to peers and one that may attract takeover interest.

Bearing that in mind, 68-year old chairman Christopher Winn sold down 3.7m of his shareholding a year ago – he still retains 8m shares, or 13.3 per cent of the issued share capital – which has widened the shareholder base and makes it more likely that predatory interest could be taken seriously by the board. But even excluding that possibility, the shares are far too lowly rated compared to peers.

### **Peer group analysis**

Sanderson has very few listed peers. This is hardly surprising given that cross vertical generic ERP providers are all multi-national large corporations such as Oracle, IBM, SAP, NCR and Sage. The most active competitor within this group is Microsoft with its Dynamics offering. Retail systems specialists such as Grantham-based Khaos

Control Solutions and Manchester-based Maginus, are privately-owned.

The closest company in terms of business model, proprietary software, and IP protection is Aim-traded **K3 Business Technology (KBT)**, a provider of software (owned and third party), cloud solutions and managed services to the supply chain sector.

K3 is a recovery play under a new management team, having faltered badly in the 2017 financial year when it posted a deep loss. The key will be restoring operating margins above 10 per cent on annual sales of around £90m. K3's operating margins were only 5.5 per cent in the 2018 financial year, a far cry from the 16.1 per cent margin Sanderson made in the same period.

Sanderson has a higher recurring revenue stream too. This accounted for 55 per cent of its turnover in the 2018 financial year, seven percentage points higher than K3's proportion of recurring revenues. Also, Sanderson's overall gross profit margin of 79 per cent is streets ahead of the pricing power of K3, which will still only have a gross margin of 55 per cent even if it hits 2020 earnings forecasts.

#### Peer group comparison

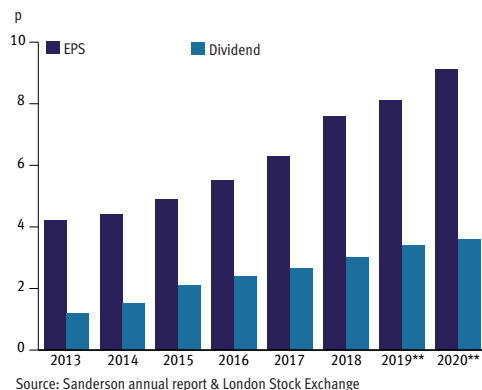
|                          | K3 Business Technology | Sanderson |
|--------------------------|------------------------|-----------|
| Share price              | 220p                   | 120p      |
| Market value             | £94m                   | £73m      |
| 2019E                    | 21.2                   | 14.8      |
| 2020E                    | 19.3                   | 13.2      |
| 2019 Operating margin    | 6.0%                   | 16.1%     |
| 2020 EPS forecast growth | 9.6%                   | 12.3%     |
| 2019E Dividend yield (%) | 0.8%                   | 2.8%      |
| 2020E Dividend yield (%) | 0.9%                   | 3.0%      |
| Net cash per share 2019E | 6.3p                   | 5.0p      |
| Net cash per share 2020E | 14.9p                  | 10.0p     |

Source: K3 Business Technologies (finnCap); Sanderson (WH Ireland); Sanderson net cash per share estimates (Simon Thompson cash flow models)

It's not just Sanderson's pricing power that is better – its earnings growth is superior too. It's worth pointing out that Sanderson's management team are notorious for being overly cautious in their guidance, so have a habit of over delivering. That's no bad thing. Nevertheless, based on what could be conservative assumptions, Sanderson is predicted to post EPS growth of 12.3 per cent in the 2019/20 financial year, whereas analysts are forecasting growth below 10 per cent for K3.

Despite its superior earnings growth and pricing power, Sanderson is rated on a PE ratio of 13 for 2020 – six points below that of K3, which is rated in line with the FTSE Small-cap software peer group average rating. Both companies are expected to end the 2019 and 2020 financial years in similar net cash positions as a percentage of their

### Sanderson's rising EPS and dividends



market capitalisations, so the capital structure of their balance sheets is certainly not a reason for the valuation disparity. Also, Sanderson's progressive payout policy means that its prospective dividend yield of 3 per cent for the 2020 financial year is more than three times higher than that of K3, so there is a better income on offer, too.

The bottom line is that Sanderson is just too cheap. That's also worth considering in light of the corporate activity in the UK listed software sector. KBC Advanced Technologies, Lombard Risk Management, Pilat Media Global, Constellation Healthcare Technologies, and earlier this month, Scisys, are just some of the Aim-traded software companies on my active buy list that have been taken over in recent years.

### Liquidity

The shareholder base is now more diversified after chairman Christopher Winn reduced his stake from 19.5 per cent in the summer of 2018, placing 3.7m of his shares with institutional investors. Mr Winn still retains 8m shares, representing 13.2 per cent of the share capital.

### Sanderson's substantial shareholdings

| Shareholder  | % of issued share capital held |
|--|--------------------------------|
| Christopher Winn (chairman)                                      | 13.2                           |
| Canaccord Genuity  | 11.6                           |
| Gresham House Asset Management                                   | 9.5                            |
| Discover Capital   | 6.6                            |
| Alto Invest  | 5.9                            |
| Brooks Macdonald Asset Management                                | 4.2                            |
| Unicorn Asset Management   | 4.0                            |
| David Renshaw (chief executive, Supply Chain Logistics division) | 3.4                            |
| J. Sanders Esquire   | 1.6                            |
| Chelverton Asset Management                                      | 1.5                            |
| R. Telford Esquire   | 1.2                            |
| Liontrust Asset Management                                       | 1.2                            |
| <b>Total</b>   | <b>63.9</b>                    |

Source: Sanderson annual report and London Stock Exchange

Importantly, the shares are readily tradable in bargain sizes well in excess of the 2,000 electronic market size. Trades in lot sizes above 10,000 shares are regularly executed between the bid-offer spread, suggesting liquidity is not a great issue, albeit it's worth noting that the top 12 shareholders control 64 per cent of the 60.5m shares in issue and 26.1 per cent of the shares are not in public hands. This means that price moves can be more accentuated than normal.

That's not an issue right now given that the board are confident of meeting this year's earnings projections, and the tone at last month's interim results was clearly upbeat, suggesting potential for more positive news flow. However, in the highly unlikely event of Sanderson missing guidance, then expect downside in the share price to be more accentuated, too.



## Meet the management

■ With an average age of 63 years, the five main board directors have a wealth of experience led by 68-year old chairman **Christopher Winn**. Following graduation from Nottingham University, Mr Winn worked for British Olivetti until 1974, when he joined the ACT Group, which became the second UK IT company to be listed on the London Stock Exchange in 1979. He served on the ACT board between 1983 and 1994, undertaking a number of senior roles before joining the former Sanderson Group plc where he led a management buy-in with the support and backing of private equity group Alchemy in 1999. Sanderson subsequently relisted on Aim in December 2004.

■ Chief executive **Ian Newcombe** has been with Sanderson for 20 years and has been in his current role for the past four years. He has over 30 years' experience in software and IT services. Starting his career in electronics, he moved into the computer industry in 1979, when he also joined ACT Group and helped establish an international IT support and software services business. In 1996, Mr Newcombe joined Mitsubishi Electric of Japan and as International Project Director he was instrumental in the formation of an online financial services business, successfully launching a range of innovative projects in the UK and Europe. In 1999, he joined Talgentra, one of Sanderson's subsidiaries, where he developed a new consulting services business which rapidly expanded overseas. In 2005, Mr Newcombe became Managing Director of the Sanderson multi-channel retail division and drove the growth of the division.

■ Finance director **Richard Mogg** was recruited in October 2017, bringing significant commercial and finance experience predominantly from software and IT services businesses. After graduating from University,

he worked for RM, a specialist in providing information technology products and services to educational organisations, where he trained to become a Chartered Management Accountant and undertook various financial management roles across the business. In 2008, Mr Mogg moved to Capita's IT services business as Finance Director and undertook a number of acquisitions leading to promotion to Divisional Finance Director of Capita's IT Services Consulting Division. Prior to joining Sanderson, he was Chief Operations Officer for Capita's Education Software Services.

■ Non-executive director **David Gutteridge** has a wealth of IT experience, too, including stints at listed companies Financial Objects, Cyan Technology and latterly Sanderson, where he has served as a non-executive director from IPO in 2004 up until 2012, re-joining as a non-executive director in June 2015. Mr Gutteridge was chairman of Tinglobal Group until May 2014, when he led a successful trade sale to Singapore Exchange listed DeClout.

■ The other non-executive director is **John Patterson**, former Managing Director of Albert E Sharp Securities stockbrokers from 1993 until its acquisition by Old Mutual in 1998. He was instrumental in setting up Arden Partners in 2002, and played an influential role in the flotation of Sanderson in 2004.

Reassuringly, the directors hold 14.6 per cent of the issued share capital between them, so have significant skin in the game. It's also worth noting that, including £340,000 of bonus payments in the 2018 financial year, their combined remuneration of £1.1m was substantially less than the £1.8m cash dividend declared to Sanderson's shareholders, so the financial interests of the directors and outside shareholders look well aligned.

### Target price

There is a strong case to make that Sanderson should be rated in line with its UK listed small-cap software peers (sub £100m market capitalisations) on a multiple of around 18 times 2020 earnings estimates, implying a fair value for the equity of 165p. Add to that a projected cash pile that realistically could swell to £6m by September 2020 - a sum worth 10p a share - and fair value of 175p for the equity looks a realistic target price on a 15-month time scale. If achieved this would value the company's equity at £105m, and on a price-to-book value ratio of three times.

Interestingly, the share price is on the cusp of breaking out to a new all-time high if it passes through the 125p high water mark achieved earlier this year. That looks a distinct possibility given the strong likelihood of Sanderson delivering more positive news flow when it reports its pre-close trading update in October. So, having taken into account all the risk factors detailed below, I feel the shares are well worth buying. **Strong buy.**

### Risk assessment

Of course, as with any investment, there are several risks to consider here:

■ **Economic.** As a supplier to the digital retail and enterprise markets, a downturn in the economic climate affecting these sectors may lead to a reduced spend on IT systems and services by existing customers and prospective ones, too. In addition, the uncertainty surrounding Brexit may lead to further slowdown in customer decision making and increased costs.

To mitigate these risks the company strives to offer solutions that provide a demonstrable return on investment for both existing and new customers, as a strategy to capture more of customers' budgeted IT spend. Also, forward-looking indicators such as order intake are regularly reviewed to identify potential deterioration in market conditions. It's therefore reassuring to know that after adjusting for acquisitions made in the 2018 financial year, Sanderson's like-for-like order intake increased by 9 per cent that year. Also, more than 14 per cent of orders were placed by customers contracting with the company for the first time. The order book held up solidly in the first half of 2019, highlighting that the cost benefits of Sanderson's product offering are compelling enough to withstand challenging economic trading conditions.

In addition, management continues to investigate opportunities arising from the potential outcome of Brexit. There could be greater pressures on logistics companies after the UK leaves the EU, thus underpinning demand for Sanderson's leading edge software solutions. Even if the UK economy weakens in the event of a hard Brexit,

demand from food and drink processors for its ERP manufacturing software suite has so far proved recession proof. Also, the company is a major beneficiary of retailers scaling up their digital offering to offset pressures on high street sales, and that's unlikely to change whatever the outcome of Brexit.

■ **Product development.** Sanderson operates in dynamic markets and must ensure the solutions it offers remain competitive. Failure to do so may lead to a loss of business with customers obtaining more relevant solutions elsewhere. To mitigate this risk, management regularly discusses business requirements with its customers and prospective customers. Approximately three quarters of product development is in response to specific requirements, thus ensuring that new product offerings accurately reflect the needs of the markets served. Product roadmaps are regularly reviewed by senior management.

■ **Product delivery.** Significant revenue is generated from projects that require the delivery of software and services over extended timescales. Project failure could result in contracts being cancelled, impacting on profitability and cash collection. To mitigate this threat, established procedures are used in the delivery and management of projects.

■ **Financial.** Inaccurate financial information may result in sub-optimal decisions being taken by management and staff. Therefore, systems of internal controls are strongest in areas where management considers the business's potential exposure to material loss to be at its greatest. This includes contract management and credit control.

■ **Customer concentration risk.** Sanderson's two largest customers account for 15 to 20 per cent of annual revenue. Sanderson continues to invest in strengthening its sales and marketing capability in order to gain further new customers thereby diluting specific customer revenue over time. Contractual relationships with larger customers are reviewed regularly too.

■ **Acquisitions.** Sanderson considers complementary and earnings-enhancing acquisitions as part of its overall growth strategy. However, acquisitions may not always realise the benefits expected, and failure to successfully integrate them may impact on profitability.

That said, the company has developed a strong reputation for selecting acquisition targets wisely, carrying out appropriate due diligence, seeking warranties and indem-

nities from vendors wherever possible, and making sure earn-outs are part of the consideration in order to incentivise incumbent management to deliver profitable growth in the future. In addition, an integration plan is formulated as part of the due diligence process and executed as rapidly as is appropriate to the nature of the business acquired.

For instance, the acquisition of One iota, a provider of cloud-based front-end multi-channel retail solutions, in October 2013 and Proteus Software, a provider of warehouse management solutions, in December 2014 were quickly integrated and have delivered the financial returns expected at the time of acquisition. The larger acquisition of supply chain logistics software company Anisa at the end of 2017 has been successfully integrated and subsequently gained eight new customers in the 2018 financial year including the aforementioned Port of Dover supply warehouse management and cargo terminal management software contract. Anisa reported 12-month pro-forma pre-tax profits of £740,000 on revenue of £10.6m in 2018, a performance that justifies the £12m acquisition price Sanderson paid. Prior to last month's Gould Hall acquisition, all earn-outs on past acquisitions have been settled, so there is no financial overhang from them.

■ **Reputational.** The quality of references obtained from existing users of Sanderson software is an important part of the decision-making process for a potential customer seeking to appoint Sanderson as a new supplier. Similarly, existing customers are more likely to extend the use of current solutions and purchase new products when they are confident solutions will be delivered on time and to budget. Poor performance or the provision of substandard products may therefore result in customer disputes as well as a negative impact on solution sales.

To mitigate this risk, Sanderson strives to maintain its reputation as a supplier of highly functional, value for money solutions. Quality control is an important part of the product development process and senior staff are involved in managing project delivery to ensure, wherever possible, solutions are delivered on time and to budget.

■ **Pension deficit.** The company operates a defined contribution pension scheme which had a charge of £757,000 in the 2018 financial year. It also has a closed defined benefit scheme with assets of £9.9m and liabilities of £13.7m into which Sanderson is making annual contributions of £540,000. This pension deficit isn't material in terms of the company's enterprise valuation of £75m, and the annual contribution can be easily absorbed, equating to less than 10 per cent of annual net operating cash flow.

■ **Foreign currency risk management.** Sanderson is predominantly a UK-focused business and has minimal currency risk. Almost 80 per cent of its gross cash balance at the end of the 2018 financial year was denominated in sterling.

■ **Credit risk management.** Sanderson invoices all pre-contracted recurring revenues up to six weeks before the renewal date. Payment terms require the invoices to be paid by the renewal date. Such invoices are only shown as overdue when the invoice remains outstanding after the renewal date has passed. Unless specific agreement has been reached with individual customers, all other invoices are due 30 days after the date of the invoice. The terms and conditions of sale permit the company to charge interest, at 4 per cent above bank base rates, on all invoices that remain unpaid 30 days after their due date.

Due to the nature of the trade, certain customers may delay payment until project-related milestones have been met. Payment terms are not contingent on milestones being met, but an assessment as to the remaining work required to be done and the potential loss of customer goodwill arising from enforcement of contractual payment terms may take place when considering actions to be taken to secure payment. The company has a good record in respect of invoiced amounts proving difficult to recover and does not ordinarily write off amounts due.

In the 2018 financial year, the company had a receivables balance of £9m and wrote off only £58,000 as uncollectable and it ended the period with a receivable impairment charge of £111,000, a tiny sum in relation to sales of £32m booked in the financial year. Although, were the economy to fall into recession, there could be scope for more impairments.



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