Q3 2022 Trading Update

Wednesday, 23rd November 2022

Introduction

Anna Engvall

Head of Investor Relations, SoftwareONE

Good morning and thank you to everyone joining SoftwareONE's Q3 2022 Trading Update. My name is Anna Engvall, Head of Investor Relations at SoftwareONE, and joining me today, are Dieter Schlosser, our CEO, and Rodolfo Savitzky, CFO.

Before handing over to Dieter, let me draw your attention to the usual disclaimer regarding forward-looking statements and non-IFRS measures on slide two.

With that, I will hand over to Dieter.

Q3 2022 Summary

Dieter Schlosser

Chief Executive Officer, SoftwareONE

Strong Performance in Q3 2022 with 17% Growth and Solid Profitability

Good morning. I am pleased to welcome everyone to our Q3 trading update. We had a strong third quarter with our integrated model of software, cloud, and services continuing to deliver across our markets.

Gross profit for the Group was up 17% in constant currency to CHF 216 million. Both business lines contributed to this double-digit growth, with software and cloud posting a particularly strong quarter. This performance is a clear indication that we are well-positioned and are meeting the needs of our customers as they prioritise digital transformation, despite an increasingly challenging macroeconomic environment.

Adjusted EBITDA was CHF 45 million, implying a margin of 20.8%, or 2.7 percentage points higher than last year. This is a solid level of profitability considering the usual seasonality. The improvement was driven by continued cost discipline and gross profit growth.

Our clear focus is on profitable growth, with adjusted EBITDA up 30%, growing significantly faster than our top line. Based on our nine months' performance and robust outlook, we are on track to meeting our target for the full year, which are mid-teens gross profit growth and an adjusted EBITDA margin above 25%.

Finally, I am pleased to announce that we will launch a share buyback programme of up to CHF 70 million, this fully in line with our growth strategy and balanced capital allocation framework presented at the H1 results in August. Our growth opportunity remains strong and investing in the business will continue to be our first priority. However, we see scope for further enhancing shareholder value by returning additional funds. Rodolfo will take you through the details of the buyback programme later on.

Broad-based Growth across Regions

Moving on to our regional performance. All four regions contributed to our strong gross profit growth. NORAM and LATAM continue to deliver double-digit growth on the back of good results in Microsoft. EMEA also delivered a strong performance, led by services, including the contribution from the acquisition of Predica. APAC dipped slightly below double-digit in Q3 at 9%, compared to a strong quarter last year. On a nine-month basis, growth in APAC was 14.3%, and in general, we see a strong demand environment in this region.

So, as you can see, the good momentum that we have seen from the beginning of the year has continued. Fundamentally, our customers continue to invest in cloud-based solutions to manage complexity and increase the flexibility, agility and security of the businesses, giving us confidence in our ability to leverage a structured, growing market over the mid-term. However, we also note that some customers, particularly in the public sector, are taking a more considered approach to their investment. They are more focused on moving to the cloud in a cost-optimised way – a journey we are also well-placed to support. As a reminder, public sector accounts for approximately 15% of our gross profit.

Growth in Solutions & Services driven by XSimples, cloud and application services

Diving into the performance of each of our business lines, Solutions & Services delivered just over 25% gross profit growth. This is down to earlier periods, when the business was scaling out rapidly, and is more indicative of the level of growth that we expect to see going forward, which is 20-30%.

In general, the performance was broad-based across service lines, across customers and geographies, which is an excellent sign that we are fully addressing our customers' needs through our broad portfolio.

XSimples, our pay-as-you-go offering for SME customers, grew 45% in the quarter, based on 365Simple and AzureSimple combined. Still, at a very strong level, the growth rate has stabilised compared to previous quarters, when the pace of transition from multi-year agreements to subscriptions was higher.

Cloud Services saw very strong growth. In particular, Azure up over 100%, due to accelerating demand from our customers, with similarly impressive performances across our other hyperscaler practices, AWS and Google. I would also like to highlight the high double-digit growth in Application Services and SAP Services, driven by customer demand for cloud-defined applications and the impending deadline of SAP migrations to the cloud.

In terms of profitability, and again keeping in mind the impact of seasonality, Solutions & Services adjusted EBITDA margin was 2.1% in Q3, up from negative territory last year, driven by operating leverage.

Positive momentum in Software & Cloud with sector-leading margin

Now, turning to Software & Cloud. Gross profit grew 11% to CHF 119 million. This extends the robust momentum that we saw in H1, driven by strong results across the hyperscalers, including Microsoft and our ISV portfolio.

Total Microsoft billings reached CHF 3.4 billion, growing at 11% year-on-year. Momentum across enterprises and SMEs was positive, with lower growth in public sector, as mentioned earlier. We also continue to see strong momentum in our expanding ISV portfolio, as we grow market share with key vendors, particularly in areas such as cybersecurity and virtualisation.

As for margin, you see that Software & Cloud was at a very impressive level of over 48% adjusted EBITDA margin in Q3, an improvement compared to last year. This is a testament to the scale and to the high level of efficiency that we have reached in this business.

Cross-selling Wins across Portfolio and Regions

Lastly, I would like to give you a few examples of key customer wins and how we help our customers in practice. Highlighting three examples, I will first mention a sizeable public sector vendor in Europe, where we will be delivering training services on Microsoft user and admin topics to help the employees work and collaborate more effectively. We are also supporting a large US consumer goods company with IT asset management diagnostics and advisory services to optimise their software costs. And thirdly, we are working with an Asia tech start up for the provisioning of Relic DevOps and security software to help them get visibility on the performance of their entire stack.

These examples are a great reflection of the diversity inherent in our business, our broad portfolio, our global footprint and right end-market exposure, which should serve us well in the current environment.

With that, I would like to hand over to Rodolfo, to take you through our financial performance in Q3.

Financial Performance

Rodolfo Savitzky

Chief Financial Officer, SoftwareONE

Strong Performance Driven by Operational Excellence

Thank you, Dieter. A warm welcome from my side as well. As Dieter already mentioned, we have delivered another quarter of strong results, with 17% gross profit growth on a constant currency basis. Keeping in mind that Q3 is a lower-margin quarter due to seasonality, the adjusted EBITDA margin was solid at 20.8%. This is well above last year's level and reflects both growth momentum and cost control measures in place since early this year.

As you can see on this slide, growth in adjusted operating expenses came down to 14% in constant currency. Adjusted operating expenses have now remained at around CHF 170 million for four quarters in a row. As a result of the strong Swiss franc, forex headwinds had a significant impact of just over 5.5 percentage points on our revenue and gross profit growth. However, given our natural hedge with similar exposures on OPEX, the forex impact on adjusted EBITDA was again minimal.

You will recall that in H1, we increased the level of transparency by disclosing the business line P&L down to adjusted EBITDA. We also introduced a new alternative performance measure called contribution margin, which equals revenue less external and internal delivery cost. As I explained, contribution margin is more appropriate measure than gross profit, particularly for our Solutions & Services business line, which now represents close to half of our total revenue. Given strong growth and strict cost control, we continue to see a positive impact from operating leverage, leading to improved EBITDA margin in both of our business lines.

Margin Improvement across Both Business Lines

Profit & loss summary by business line

In Solutions & Services the contribution margin was CHF 43 million, or 37% of revenue, comparing favourably to peers and up by 2.6 percentage points versus the prior year. SG&A grew at a materially lower rate than the top line, translated into an adjusted EBITDA margin of 2.1%, in line with our expectations given seasonality. With high revenue growth and a strong contribution margin, EBITDA margin will continue to increase over the coming quarters and reach our target of around 15% of revenue by 2025.

In Software & Cloud, we also see a positive impact from operating leverage, with contribution margin growing ahead of revenue, and EBITDA growing faster than contribution margin. EBITDA margin remains strong at 48%, and importantly at a level which has been both healthy and sustainable.

On Track to Deliver Operational Efficiencies

Scope of new efficiency programme

Moving on to the next slide, as already mentioned at H1 results, we are launching a wide-ranging efficiency programme to maximise the impact of key functions and to ensure a best-in-class cost structure, with some of the savings being reinvested in innovation and growth. This programme aims to improve our commercial model, optimise our operational delivery, and right-size key support functions, such as Finance and HR. Since August, we have made significant progress across all three areas.

Regarding our salesforce, we are increasing its productivity by ensuring the optimum mix of business development executives and account managers, and by reducing and right-shoring non-customer-facing roles. We are leveraging our next-generation sales programme to improve governance, incentives, and tools to maximise return on our sales investments.

In our Solutions & Services delivery network, we have undertaken an exercise to drive an optimum shoring mix, and an efficient organisational structure in terms of layers and spans[?] of control. The transition to a more streamlined operating model is already underway.

And finally, we will be improving productivity metrics across our support functions by both transferring transactional activities to our shared service centres and leveraging functional centres of excellence at global or regional levels. With these measures, we aim to reduce fragmentation of resources across country organisations.

In terms of timeline, we will have the full project blueprint, including productivity targets, ready for disclosure together with our full-year results in March 2023.

Launch of Share Buyback Programme of Up to CHF 70 million

Given the strength of our business model and healthy balance sheet, combined with our focus on optimising shareholder return, we have today announced our intention to launch a share buyback programme of up to CHF 70 million. The programme will start in early Q1 2023 and will be executed on a second trading line on the SIX Swiss Exchange. Our intention is to propose a capital reduction and subsequent cancellation of the bought-back shares at future AGMs. Further details on the programme will be available on our website prior to launch.

Working capital

I also want to provide a brief update on working capital. Given its relatively high level at the end of June 2022, we have taken specific measures to reduce it. The year-on-year increase in net working capital position at the end of quarter three has narrowed approximately CHF 40 million, compared to CHF 200 million at the end of June. While we will continue to optimise payment terms with vendors and customers, we expect to be above last year's December position, as we seek to achieve a normalised or more sustainable level of working capital over time.

Guidance Reiterated

Moving on to our guidance. It is important to keep in mind, that, as always, December is a critical month for the year, and will determine where we land within our guidance range. Given our year-to-date performance and robust outlook, I reiterate our guidance for the year and for the mid-term. We expect to deliver mid-teens growth in 2022, and adjusted EBITDA margin above 25%, and a dividend pay-out ratio of 30-50% of our adjusted profit for the year.

Finally, let me remind you that from 2023 onwards, we will start guiding for growth based on revenue, and EBITDA margin will be calculated as a percentage of revenue and not gross profit. We will, of course, continue to provide visibility between old and new metrics to ensure full apples-to-apples comparison.

Let me now hand over to Dieter, for his closing remarks.

Closing Remarks

Dieter Schlosser

Chief Executive Officer, SoftwareONE

Key Take-aways

Thank you, Rodolfo. As we reach the end of our presentation, there are three messages that we would like you to take away today. Firstly, our Q3 results confirm that we are on track to meet our 2022 guidance of mid-teens growth and an EBITDA margin of above 25%. Secondly, we remain fully committed to our growth strategy, supported by our operational efficiencies to deliver profitable growth. This drives continuous cash generation and further returns to our shareholders. And thirdly, we have taken important steps this year, in terms of increasing the level of transparency in our financial disclosure, and this will continue to be a priority in 2023.

Thank you. And we will now take your questions.

Q&A

Michael Briest (UBS): Morning, and congratulations on the good Q3. There are a couple from me. Could you give more colour around the cost and efficiency target that you report on slide 12, just some scope of how much magnitude we could expect for exceptionals and the planned savings?

And then in terms of the macro environment, Dieter, obviously, good growth in Q3. You called out public sector. I know in the past, SME has been an area of weakness. However, is there any more colour you can give on the linearity, October trading, which maybe informs your outlook for next year as much as Q4?

And then, Rodolfo, on the cash flow, can you just clarify what you said about working capital? Will it be up by less than CHF 40 million year-on-year by year-end? Was that what you were saying, that should then be a more sustainable level? I could not quite understand that. Thank you.

Dieter Schlosser: Yes. Thanks and hi, Michael, for the questions. Yes, starting with the operational excellence, as we have shared, as Rodolfo has shared, we will give the full outlook on that, with the full year's results, on 2nd March 2023. However, Rodolfo, if you give a bit more colour on this now, and then also to the cash flow. I will then answer the macroeconomic question.

Rodolfo Savitzky: Yes, very good. In terms of the savings, we can disclose today, as we did in the first half, that the minimum level of savings we see, is in the mid-single-digit percentage of our cost base. And we will provide more specific targets, as Dieter said, with the full-year results. At this point, we cannot elaborate more on that.

Of course, like you mention also, would there be any restructure [inaudible], and again, as with any optimisation programme, there will be the need for some restructuring cost, and we will provide details on that as well, early next year, with the full-year numbers.

Then, on cash flow, the number I quoted during the presentation, the higher working capital position of CHF 40 million in September, compared to the CHF 200 million higher position in June, of course, it is emphasising that we have increased control on our net working capital and we are reducing it compared to prior year. However, I also mentioned in the H1 call that the level in December 2021 was extraordinarily low, compared to the usual average level of net working capital.

What this means is, as we approach December, we will be at a higher position than we had in December 2021, but I expect that the delta would not be too different from the position last[?] December. However, again, we are seeking to move to a more sustainable level of working capital and that will translate into a higher position towards the end of the year, compared to December 2021.

Dieter Schlosser: Fine. Thanks. On the macroeconomic demand environment, Michael, you have seen now for the last nine months, we had a very solid demand environment, and we have outlined that we see one factor, which is the public sector, being more considerate in their approach of adopting new technologies. Going forward and for the rest of the year, which is a couple of weeks ahead of us, you do know, from a seasonality point of view, December is a very strong month for us and that, basically, will drive also where within our guidance we will land.

If I look back, Michael, you remember 2020, we had no flash-out[?] of the budget at the year-end[?] of customers. 2021, last year, we had a flash-out of the budget, the IT budget, which is a non-common scenario in the technology and in the industry. At the year-end, usually, IT organisations are spending the remaining amount of the IT budget. Provided this is coming, then we do not see any impact on the demand. However, as I said, in the last two years, we have seen one year of this, and one year result, 2020, was obviously the COVID year.

In terms of 2023, from our point, the [inaudible] and the service[?] of the market remains absolutely strong and relevant for us. I think we are super-positioned with our portfolio. Somehow, it hits the nail on the head because every single pain point the customer has, we are addressing with our portfolio, whether it is a cost optimisation with DevOps[?], or whether it is moving to the cloud, whether it is modernising and moving into the cloud, or whether it is deadlines like we see on SAP into the cloud. From that angle, we are very well-positioned on Software & Cloud; we believe with our engine and with our geo coverage, we are very well-positioned.

Structurally also, and from a geopolitical environment, I think our local coverage with global best practices is best-in-class, so we are positive on that angle. However, looking ahead, I think we are doing this then in March when we do the full-year presentation for 2022 and give the guidance for 2023.

Michael Briest: Understood. And any observation on Microsoft, expected deceleration in Azure and elsewhere, does that not affect you?

Dieter Schlosser: Yes. You always have to look with a different eye onto the Microsoft numbers because it combines 3.5 clouds and it also combines of end-customer commerce, etc., etc. If you break it down, the growth on everything which is cloud, and in particular Azure, it is still very solid. And I think if you look also at the demand from the customers, where they really need to accelerate cloud migrations, I do not think there is a slowdown on the consumption side. Thus, I am positive on this. Of course, the overall revenue then reflects many, many areas where we are not participating, and that is also where we are choosing to participate in the ones where we can also have profitable growth behind it.

Michael Briest: Thank you very much.

Speaker (JP Morgan): Yes. Good morning, a couple from my side. Just firstly, just on the macro. When we look across the board, we are seeing signs of softening across the broader ecosystem – sales cycles lengthening, deals requiring extra approval and so on. And I know you called out public sector specifically here as an area of weakness. However, outside of that, are you seeing any other signs of slowing linked to the macro?

And then perhaps again, just coming back on the working capital side of the business. You talked, obviously, about continuing to optimise payments terms with vendors. Can you just give us a sense as to what gives you the confidence you can continue to improve things here in an environment where customers are presumably going to be holding onto cash a lot more? Thank you.

Dieter Schlosser: Yes. Thanks and welcome to the team. Again, from a macro point of view, a side of the customer, which I mentioned earlier, yes, here and there you see delays in terms of decision-making, that is absolutely right. However, if you are in a segment where you either keep the lights on or you make the lights brighter, there is not much discretionary budget that the customer can actually cancel without shutting down considerable functionality in their businesses. At the moment, we do not see a cancellation. We see here and there some delays. And what you said also is true, sales cycles are expanding a bit. However, it is delays. It is not cancellations at the moment.

And from cash flow, you want to answer that?

Rodolfo Savitzky: Yes. If you look at the recent trends over several quarters back, we continue to have net working capital under tight control. When we look at the theoretical terms that we have with our customers, they are well-balanced. We are very diligent when it comes to credit rating of our different customers. We do not see at this point in time any problem with collections. We believe we can continue to manage our DSOs at an average of over six years – we have shown before. Then when it comes to payment terms with vendors, again, we do not see any fundamental change in vendor payment terms, and we believe we can continue to optimise those terms, as we have done in the past. Thus, I do not see any issues continuing with the very effective management of the net working capital.

Speaker: Understood. Thank you.

Andreas Muller (ZKB): Yes. Good morning, gentlemen. Thanks for taking my question. The first one is actually on the growth momentum in Solutions & Services which was a take below the guidance for the year. What was the impact there of external growth and are there any specific reasons also why it went down from 36% to 25%?

And the next question is on earn-outs. Are they going to stay at that level, given also that on the acquisition front, it was somewhat quiet recently?

And then my third question is on the buyback programme. Was that the result actually of this lower acquisition activity? And also going forward, is that pointing to that, or is it just a result of the good operating performance? Thank you.

Dieter Schlosser: Yes. Hi, Andreas, thanks for the questions. On Solutions & Services, you rightly pointed out that we are slightly down to 25.3% in Q3. As you might have seen also in the presentation, you see a deceleration on the XSimples, our bundles, which is a transition from our three-year[?] commit to a subscription-based pay-as-you-go. We are reaching the tail end over there. And as you might recall, our focus was always to go towards our own book of business because we are the incumbent over there, and we wanted to make sure that we are placing ourselves in there, and not opening the door to the competitive landscape. So it was very much focused on converting existing book of business to pay-as-you-go. And now since we are reaching the tail end of that, there is a more realistic growth of 45%, which you see in constant currency is 50%, which has also an impact on the overall growth.

Going forward, that of course allows us again room. Because, in the next six months or so, we can pivot further to go deeper into the converted existing book of business, on the one side, but also start hunting net new business in that area, which will be done, of course, with strategic attention on it. And also, if you see the scale which we have, in the meanwhile, reached, we are talking about CHF 0.5 billion business on Solutions & Services. Basically, we reached, correlated to Software & Cloud, a [inaudible] run rate. This allows us also to be more selective and not to use any door opener or any entry into the customer side, regardless whether that is a long-term strategic point for us or not, so we become more choosy on that. We focus more on retained professional services. We focus more on, is the end-game really possible with the match[?] service.

You will see that going forward, our growth on Solutions & Services will be rather in the range of 20-30% to have really sustainable and profitable growth in this area.

On earn-outs, you mention it is quiet. It is not quiet on the pipeline, but it is only quiet on the conversion of the pipeline of M&A targets. The multipliers are slowly coming down and we are waiting eagerly that they come in a realistic range. You should see in 2023, a different uptake on that. Rodolfo will add more information on this, as well as on buyback, which is still our capital allocation framework.

Rodolfo Savitzky: Yes. Let me step back for a moment on the capital allocation. Again, Dieter reiterated that in his comments, and I did the same, our priority remains number one, to support our growth momentum; to support our bolt-on M&A strategy in Solutions & Services; and, of course, to optimise also the returns to our shareholders through our dividend and when possible, like in this particular case, a share buyback.

Now, to your question, Andreas, it is not that we are slowing down on the bolt-on M&As going forward. We will assess – whenever, as Dieter said, we find the right targets at the right prices, we will continue to leverage those, as we want to continue to build[?] capabilities in Solutions & Services.

And the buyback is more a reflection of, as I mentioned, a strong balance sheet and an opportunity to provide high PSR[?] for our shareholders.

And then the earn-outs, as Dieter said, we will continue to have combinations of up-fronts and retention and earn-out payments to the owners of companies we acquire. We will continue to see that in the future.

Andreas Muller: Okay, thanks.

Dieter Schlosser: Thanks, Andreas.

Knut Woller (Baader Bank): Hi, thank you. Just three questions. Firstly, looking at the efficiency programme, I understand that you will provide some more details with the release of the Q4 results. However, looking at three pillars of the efficiency programme, can you give us an idea from a qualitative perspective which pillar is expected to be the major contribution to the efficiency gains expected going forward, and to which extent should we see a net positive impact, looking at rising inflation and the efficiencies? Do you expect a net tailwind or will it be overall a neutral effect looking at inflation?

Then secondly, on the margin of Solutions & Services, if I understood you correctly, you said you are targeting 15% over the coming quarters and years. Apart from the scaling, or drilling a bit further down into the scaling impact, can you give us some more colour on the expected margin drivers?

And lastly, on the operating momentum, did you see any material changes so far in the final quarter of the year? I understand December is the most important month of the quarter. However, did you see any noticeable changes in October-November from what you have observed in the third quarter? Thank you.

Dieter Schlosser: Yes. Thanks and very good points. And also on the three pillars of the operational excellence, I will let Rodolfo answer that in a minute. Let me take the margin discussion on Solutions & Services.

To reiterate, we target, by 2025, a margin of 15%. And you have seen how we are trending this year from a positive momentum. It is scale, you are absolutely right, it is scale, but that is not the only way. One pillar which Rodolfo will mention is also our delivery model, that is the middle pillar of the operational excellence, and that is where we optimise quite heavily. It is not only the right capability in the right place for the right price point, but also behind the delivery capabilities, what we can further automate and make sure that we separate GP growth from OPEX growth. That is the second piece which is the delivery model.

And the third piece is, in the meanwhile, we a different standing with our customers where the proof points of, are we able to deliver Solutions & Services has been given. In the beginning, we had to take any door opener, which I mentioned earlier, because we were known for value-added reasons and why should anyone from the customer give us their crown jewels on the services side if we have not given the proof point. We started off with a lot of professional services, a lot of proof-of-concepts just to get a foot in the door and then expand from there.

There we have reached a level of maturity and also reputation in the market where we can go into the higher-margin business on an ongoing basis. This goes also in line with learning to sell on value and output and outcome for the customer and impact, and not selling against price which you do in the beginning as well. You see also a higher margin outcome because of the way we are structuring this against something which Rodolfo will say on operational excellence.

In terms of operating momentum, I was thinking earlier when Michael asked a similar question and also [inaudible] a question. If I look at the metrics which would give me an indication, there are three, four metrics which are relevant. First one is pipeline growth. The second one would be conversion of the pipeline, the conversion ratio, but also the cycle time of it. The third one would be, what is the average fees which we are seeing. And the fourth one would be, do we have a growing backlog or do we have a diminishing or flat backlog.

At the moment, we do not have any indication which points us in a different direction over there. And that is why we are saying that the variable is basically the year's end this December on this and nothing else.

Now, I am handing over to Rodolfo on operational excellence.

Rodolfo Savitzky: Yes. Back to operational excellence and expected savings and what are the different buckets of savings. When you look at our P&L, particularly the ones by business line and the different cost elements, of course, from a price[?] of the cost line, delivery is the biggest one. And then, of course, when you look at the rest of the OPEX, you can imagine that Sales and Marketing represents a bigger proportion than functions like HR and Finance.

Now, at this stage, I would say for the different buckets, of course, there would be ranges of savings. However, we continue to see, at this stage, a minimum of mid-single-digit for the three buckets.

Now, there is a very important point to keep in mind. We continue to see increased operating leverage, meaning our costs are growing less than revenue. You have seen that in quarter three. Now, when we think about going forward, we reiterate that our guidance of mid-teens growth. That means, of course, our cost structure will also have to grow to support the revenue momentum. However, with this efficiency programme, we will be able to significantly grow OPEX even less so than revenue. That is something to keep in mind.

To your comment, yes, we have factored in inflation for next year. It is normal. We also have inflation in the revenue, so there is an OPEX[?] element there. We also need a certain level of growth. However, the growth will be much slower – also some growth on expenses – but it will be much slower given these efficiency measures I have put in place. And of course, as you can imagine, they will not all happen in quarter one. There we will get the low-hanging fruit and the programme will need to be implemented over the next, call it 18-24 months.

Knut Woller: Excellent. Thank you.

Dieter Schlosser: Thanks. All right, I think then we can close the session. We have, later on, a detailed analyst call as well. I am looking forward to speaking to you at that time. Thanks for your attention. Thanks for participating. Thank you very much.

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