SOPHEON

SOFTWARE & COMPUTER SERVICES

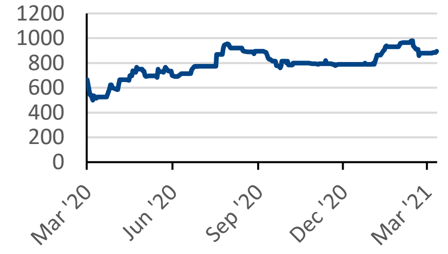
24 March 2021

SPE.L

895p

Market Cap: £93.4m

SHARE PRICE (p)



12m high/low	980p/500p

Source: LSE Data

KEY DATA

Net (Debt)/Cash	$21.6m *(at 31/12/20)*
Enterprise value	£77.8m
Index/market	AIM
Next news	AGM, 10 June '21
Shares in Issue (m)	10.4
Chairman	Barry Mence
Chief Executive	Andy Michuda
Finance Director	Arif Karimjee

COMPANY DESCRIPTION

Sopheon is an international provider of software and services for product life cycle management

www.sopheon.com

SOPHEON IS A RESEARCH CLIENT OF PROGRESSIVE

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Resilient base as Sopheon transitions to SaaS

Sopheon has reported FY 2020 revenues in line with the $30.0m guidance given in its January trading update with adjusted EBITDA a little ahead of expectations at $5.9m. We view this as a resilient performance in the face of COVID-related headwinds and as it is the Group's first full year of concluding Software as a Service (SaaS) contracts for new customers - the mix shift means that much of the associated revenue will be recognised in future years. The Group retains a strong cash position. We introduce estimates for FY 2021E and FY 2022E which reflect the solid base as Sopheon invests in the transition to cloud-based solutions and sees an increased bias towards SaaS in its contract mix. The Board changes announced emphasise the focus on pursuing growth opportunities – particularly as Sopheon is actively looking at making acquisitions to complement its organic growth as it continues to evolve its business model. M&A could, of course, make a considerable difference to the pace of change within the Group.

- The announcement of Board changes maintains continuity of oversight of execution of the Group's strategy with Greg Coticchia heading the cloud strategy as CEO, and Andy Michuda moving from that position to Executive Chairman with a brief that includes responsibility for partnerships and acquisitions.
- Annual Recurring Revenue (ARR) closed FY 2020 at $18m, an historically high level, up from $15.9m at the end of FY 2019.
- The growth in Total Contract Value (TCV) of sales booked in the year was previously noted at 25% - including a near tripling of the TCV of new SaaS contracts booked. The announcement confirms that six of the new deals signed exceeded $1m in initial TCV.
- With clients ever-more comfortable with cloud products, Sopheon is investing in the development of new cloud-native solutions which should provide the Group with upsell opportunities to Enterprise Accolade customers.

Sopheon has evolved its management team to drive focus on this transition to delivering cloud-native solutions and growing the revenue bias towards larger SaaS contracts. While the latter will have an impact on revenue recognition and the former will see higher investment and running costs, we think that the foundations which the Group is building will stand it in good stead. The likelihood of M&A to support its organic growth holds further promise.

FYE DEC ($M)	2018	2019	2020	2021E	2022E
Revenue	33.9	30.3	30.0	32.7	35.8
Adj EBITDA	9.4	6.4	5.9	4.5	4.9
Fully adj PBT	6.9	3.1	2.2	0.5	0.6
Fully adj dil EPS (c)	59.8	26.5	17.8	1.4	3.2
EV/Sales (x)	3.2x	3.6x	3.6x	3.3x	3.0x
EV/EBITDA (x)	11.5x	16.8x	18.3x	24.0x	22.1x
PER (x)	20.8x	46.9x	69.8x	885.7x	392.9x

Source: Company Information and Progressive Equity Research estimates.

FY 2020 and beyond

COVID-19 effects

Some of Sopheon's target market segments were directly impacted by COVID-19 during FY 2020, but the majority were not. In the latter group, for instance, several clients expanded their use of Accolade. Unsurprisingly, the Group saw a lower than normal client retention rate in H1 2020 although retention rates rebounded in H2. So, despite the impact of COVID-19, the Group booked more in net new contract value in 2020 than in 2019 and successfully completed several new client deployments, including the previously announced contracts with Mondelez and Orion Engineered Carbons, on a remote basis.

Outlook

The outlook comments from management reflect the shift towards SaaS but add a reminder that the Group still expects to sign some perpetual licenses, mainly with existing customers. Visibility for the current year stands at $24.5m at the moment, compared to $21.2m a year ago which gives confidence on visibility for FY 2021E. We also note the investment which the Group is undertaking in terms of headcount and the cost of developing a new cloud platform – points we touch on later when we discuss estimates.

Board changes

The announcement states that Greg Coticchia (who has over thirty years' experience in software products and services) will join the Board and 'spearhead cloud strategy as CEO', with Andy Michuda becoming Executive Chairman. Barry Mence will step down to a non-executive role. These changes will take effect from 31 March 2021.

In October 2020, Sopheon announced the appointment of Greg Coticchia to take responsibility for day to day operations and to accelerate the Company's SaaS transition. It was noted that he had been responsible for driving both organic and acquisition-led growth in a number of businesses, serving as CEO, President or COO, as well as working in marketing leadership roles. He has been involved or responsible for the launch of over 100 products and solutions and 'is a recognized authority within the fields of product management and product development', rendering well placed to lead Sopheon's strategic transition.

As Executive Chairman, we expect that Andy Michuda will continue to have specific responsibility for partnerships and acquisitions as well as governance.

Product development

Sopheon continues to focus investment in its product development on the new cloud-native solutions and the existing core enterprise platform. The group will reflect the changes in working patterns that are taking place and, as outgoing Chairman Barry Mence notes, will 'introduce a low cost, high volume market "pull" sales model by targeting innovation professionals in our target markets'. This is expected to produce opportunities to upsell to enterprise clients with the new cloud products able to integrate with Sopheon's current enterprise solution. That should also lead to existing enterprise customers migrating to the cloud applications. Meanwhile, the Accolade 13.1 and 13.2 releases were issued during 2020; with another two due for release in 2021.

Product focus driven by evolving client comfort with cloud

As we have seen across the sector, clients have become ever-more comfortable with cloud products in recent years. Sopheon introduced a SaaS First program which resulted in over half of net new clients in signing SaaS contracts in FY 2020. That shift in mix is expected to increase in FY 2021. In addition, the Group introduced a SaaS Uplift program to assist active maintenance-paying clients to transition to the cloud. Four clients converted to SaaS in FY 2020 with Sopheon targeting its perpetual on-premises clients further in FY 2021 to achieve further transitioning.

In tandem with the above, Accolade continued to gather new clients during FY 2020, some of whom we refer to elsewhere, including companies in the food and beverage, consumer goods, chemicals and defence sectors. As we have seen in previous periods, Accolade has expanded its use cases to support additional business needs. In a trend identified during the last year, the convergence of physical and software innovation has seen companies struggling to manage the governance between the physical and software aspects of their products. Again, an addressable target market which Research & Markets expects to exceed $2 trillion by 2025, is a clear opportunity for Accolade.

Non-organic growth

Management highlights two main routes to achieving non-organic growth: partnerships and acquisitions.

Partnerships

Sopheon currently utilises three types of partnerships:

Technology Partners provide enabling technologies and integrations that broaden Sopheon's solutions and reduce internal R&D. For example, Sopheon released an integration between Accolade and Microsoft Teams in FY 2020 which enables the use of the Teams platform for workstream collaboration on product and enterprise innovation initiatives.

Reseller Partners allow Sopheon to sell and support Accolade in regions that require specialised, local knowledge and expertise. It currently has reseller partners in Australia, New Zealand and China. In addition, Roadmapping Technology supports certain sectors in the UK.

Consulting Partners provide specialist innovation management expertise that support successful implementation of Sopheon's Enterprise Innovation Management solutions.

Acquisitions

The announcement also flags the Group's intention to add new cloud capability and market presence through acquisitions – something which could speed up Sopheon's evolutionary transition.

In terms of acquisitions, Sopheon states that it is 'actively researching opportunities for M&A' which would extend the capabilities of its solutions - helping its relationships with existing customers or attracting new customers - or extend its geographic reach. Any acquisitions would have to fit with the Group's strategic aims.

FY 2020 numbers

Revenues and sales bookings

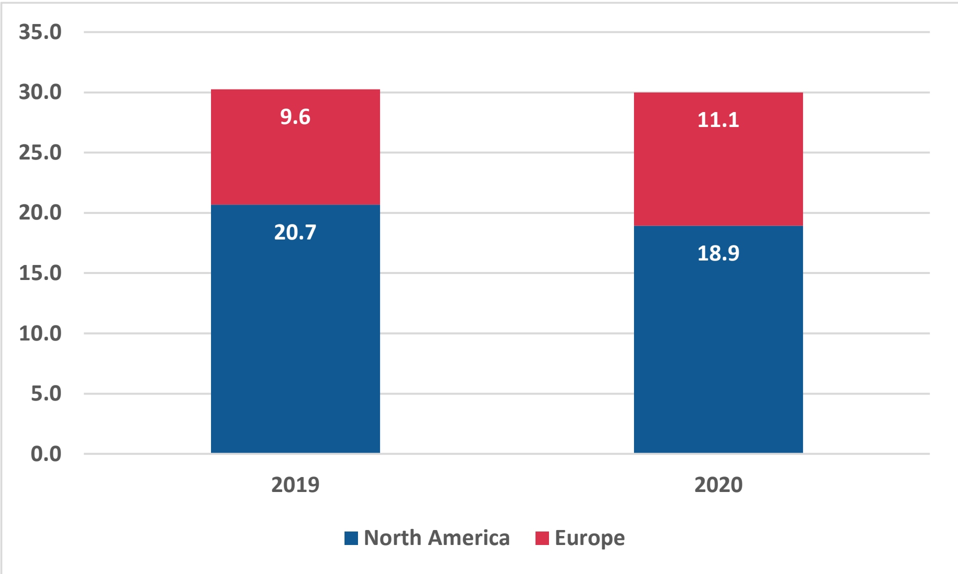
While sales bookings increased, FY 2020 revenue was at a similar level to the prior year – and in line with guidance - at $30.0m (FY 2019: $30.3m). As we note earlier, we see that as a good performance in light of the operating environment and the Group's increasing number of SaaS contracts in the mix.

The 43 (of which 10 were new) license transactions in FY 2020 compared to 47 (18 new) during FY 2019. The shift towards SaaS can be seen with 22 SaaS contracts compared to 9 in the prior year. Just as important was the move towards higher value contracts with 8 at $1m or more compared to 2 in FY 2019. The Total Contract Value of SaaS business almost tripled to $6.6m. Recurring revenue from maintenance, hosting and SaaS rose to $17.3m from $15.5m in FY 2019. ARR at the end of the year had risen to $18m (2019: $15.9m). The TCV of all contracts signed in 2020 rose by 25% to $21.2m. Otherwise, ARR growth was held back by gross retention at 91.5% compared to 94.2% in FY 2019 – still a good number in our view, given the market backdrop in H1 2020, in particular.

There continued to be a degree of seasonality to revenues with 54% in H2 – a similar level to that seen over the previous two years given the importance of sales bookings in Q4 – although the transition to more SaaS contracts will make that a less relevant metric compared to recognised revenues.

The United States and Europe continued to represent the lion's share of revenues in FY 2020 but the Group saw useful signings in Korea, Canada, Australia, Japan and Turkey. The Group's segment reporting shows the main two regions in the chart below.

Segment revenues ($m)



Source: Company information, Progressive Equity Research

Pipeline

Looking forward, revenue visibility for the year is $24.5m compared to $21.2m at this time last year. After a dip in H1 2020, the pipeline saw a rebound in H2, ending up 10% higher than it was at the end of 2019 and reflecting the rising levels of SaaS opportunities and increasing numbers of larger deals.

Gross Margin

The gross margin was 69.8% compared to 70.1% in FY 2019 reflecting a consistent performance.

Research and Development

Product development expenditure increased to $6.9m in FY 2020 from $6.4m in the prior year. R&D in the Income Statement increased from $5.7m to $5.9m reflecting the effects of capitalisation and amortisation of development costs.

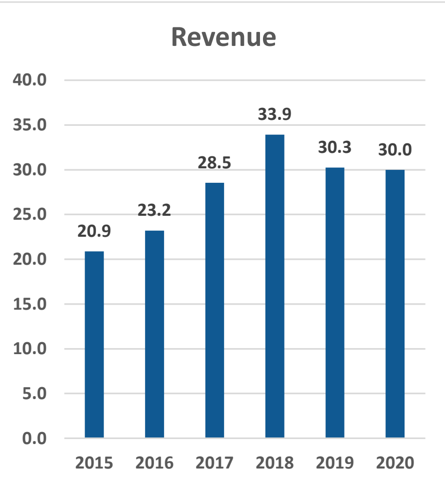
Other Operating Costs

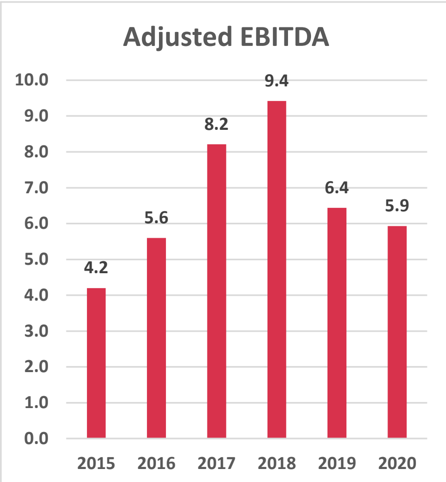
Staff costs continue to represent over 75% of Sopheon's cost base and the group ended 2020 with 169 staff, compared to 162 at the end of 2019, many of whom were hired late in the year given the uncertainties that abounded earlier in 2020. Average headcount for the year was 165 (FY 2019: 160). Non-payroll costs reflected a similar story to elsewhere in the sector with reduced travel costs contributing to a reduction of $1.1m. Overall costs in sales and marketing increased by around $0.3m while admin costs have fell slightly by around $0.1m.

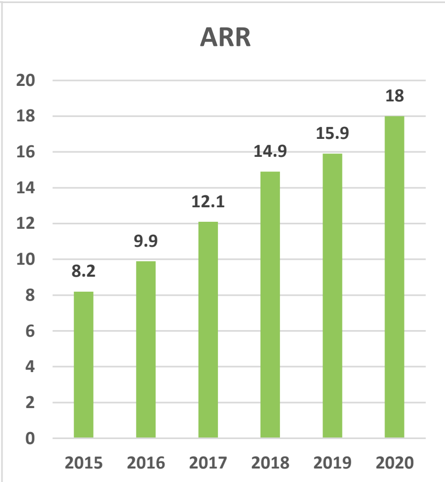
Profitability and taxation

Adjusted EBITDA of $5.9m was $0.3m ahead of guidance given in January for FY 2020 versus $6.4m in 2019. Profit before tax reduced to $1.7m (2019: $2.5m) reflecting higher amortisation associated with capitalised development costs.

Group results ($m)







Source: Company information, Progressive Equity Research

The tax charge of $0.2m (2019: $0.4m credit) reflects accumulated tax losses such as those at the US federal level, together with charges of approximately $0.1m each in Germany and for state taxes in the US. A $2.6m deferred tax asset is recognised at both 31 December 2019 and 2020, of a total potential asset of $11.1m (2019: $10.6m).

Profit after tax was $1.5m compared to $2.0m in FY 2019 resulting in fully diluted unadjusted EPS of 14 cents (FY 2019: 19 cents).

Sopheon has declared a maintained dividend of 3.25p.

Cash and facilities

The Group ended FY 2020 with cash of $21.7m and no borrowings. Given its high level of cash at the end of the previous year ($19.4m) Sopheon allowed its revolving line of credit facility with Silicon Valley Bank to lapse in February 2020. With a heightened focus on potential M&A, management notes that its relationship with Silicon Valley Bank 'remains strong with potential established for funding arrangements in connection with M&A or other corporate activity'.

Estimates

Our estimates overleaf reflect 9% - 10% growth per annum in revenue over the next two years in spite of the effects of the shifting bias towards SaaS contracts as we note Sopheon's success in sourcing new business. However, we are also cognisant of the fact that the Group will effectively be supporting two platforms for some time as it transitions Accolade into a cloud-based solution. While the new platform is set to underpin new business volumes, it will also incur costs and we have already seen the build-up in new hires during H2 2020 which will spawn higher full year staff costs from now on. Consequently, we have been quite cautious in our estimates for adjusted EBITDA while Sopheon remains in the early stages of its investment programme. We would expect to see faster improvement in adjusted EBITDA beyond FY 2022E but do not expect to address estimates beyond our current horizon in the near term.

We have used a nominal tax charge of $0.3m per annum as our best estimate of the impact of US state taxes and those in Germany, despite the overall loss position of the Group over the two years.

Given the pattern of our estimates, we have assumed that the Group maintains its dividend at 3.25p per annum over our two-year forecast horizon. Clearly, we would hope that in 2023 and beyond, with the group reaping the rewards of both the current investment and the migration to SaaS revenue models, there may well be scope for a sustained and significant increase in dividend over time.

Financial Summary: Sopheon

Year end: December ($m unless shown)

PROFIT & LOSS	**2018**	**2019**	**2020**	**2021E**	**2022E**
Revenue	33.9	30.3	30.0	32.7	35.8
Adj EBITDA	9.4	6.4	5.9	4.5	4.9
Adj EBIT	6.9	3.0	2.2	0.5	0.7
Reported PBT	6.4	2.5	1.7	0.1	0.2
Fully adj PBT	6.9	3.1	2.2	0.5	0.6
NOPAT	6.3	2.8	2.0	0.5	0.6
Reported Dil EPS (c)	65.0	19.2	14.1	(2.3)	(0.5)
Fully adj dil EPS (c)	59.8	26.5	17.8	1.4	3.2
Dividend per share (p)	3.25	3.25	3.25	3.25	3.25
CASH FLOW & BALANCE SHEET	**2018**	**2019**	**2020**	**2021E**	**2022E**
Operating cash flow	9.8	7.1	6.6	3.8	2.8
Free Cash flow	7.0	3.4	1.9	(0.1)	(0.1)
FCF per share (c)	65.6	31.6	17.8	(1.0)	(0.6)
Acquisitions	0.0	0.0	0.0	0.0	0.0
Disposals	0.0	0.0	0.0	0.0	0.0
Shares issued	0.2	0.1	0.1	0.0	0.0
Net cash flow	7.2	2.7	2.4	(0.1)	(0.1)
Overdrafts / borrowings	(0.4)	0.0	0.0	0.0	0.0
Cash & equivalents	17.1	19.4	21.7	21.6	21.6
Net (Debt)/Cash	16.7	19.4	21.7	21.6	21.6
NAV AND RETURNS	**2018**	**2019**	**2020**	**2021E**	**2022E**
Net asset value	25.6	27.9	30.2	29.4	28.9
NAV/share (c)	252.2	274.2	289.0	280.8	274.5
Net Tangible Asset Value	0.5	0.5	0.5	0.6	0.6
NTAV/share (c)	5.2	5.0	5.1	5.5	5.8
Average equity	22.1	26.7	29.0	29.8	29.2
Post-tax ROE (%)	28.7%	10.5%	6.7%	1.5%	2.2%
METRICS	**2018**	**2019**	**2020**	**2021E**	**2022E**
Revenue growth	18.9%	(10.8%)	(0.9%)	9.0%	9.6%
Adj EBITDA growth	14.7%	(31.6%)	(8.0%)	(23.8%)	8.5%
Adj EBIT growth	19.6%	(55.9%)	(26.9%)	(76.5%)	37.0%
Adj PBT growth	30.5%	(55.5%)	(30.0%)	(79.0%)	42.7%
Adj EPS growth	17.5%	(55.6%)	(32.9%)	(92.1%)	125.4%
Dividend growth	30.0%	0.0%	N/A	N/A	N/A
Adj EBIT margins	20.3%	10.0%	7.4%	1.6%	2.0%
VALUATION	**2018**	**2019**	**2020**	**2021E**	**2022E**
EV/Sales (x)	3.2	3.6	3.6	3.3	3.0
EV/EBITDA (x)	11.5	16.8	18.3	24.0	22.1
EV/NOPAT (x)	17.1	38.7	55.3	235.0	171.5
PER (x)	20.8	46.9	69.8	885.7	392.9
Dividend yield	0.3%	0.3%	0.3%	0.3%	0.3%
FCF yield	5.3%	2.5%	1.4%	(0.1%)	0.0%

Source: Company information and Progressive Equity Research estimates

24 March 2021

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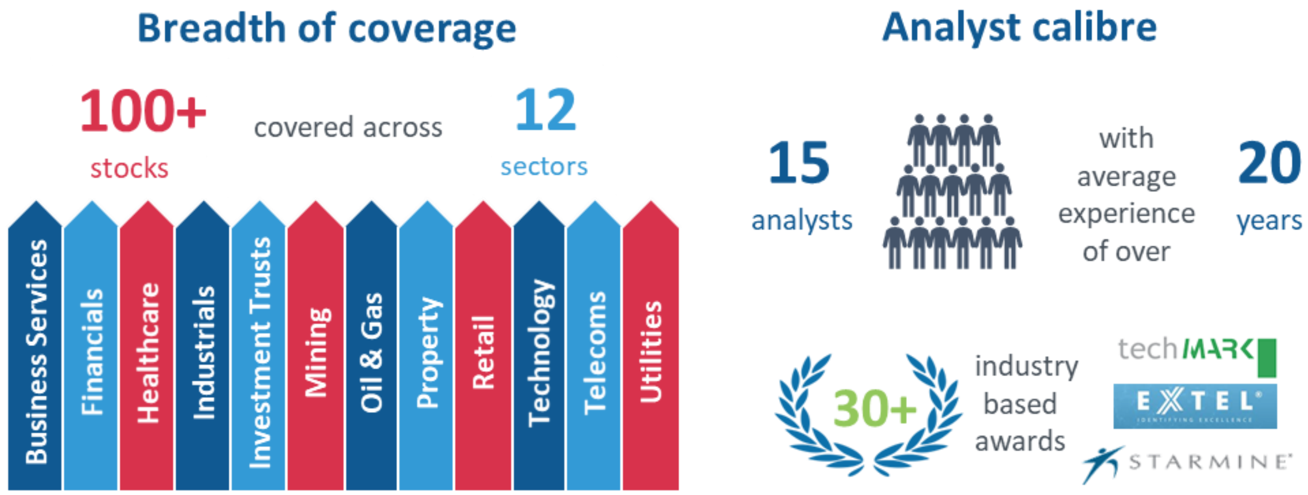

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