

Hunting for compounders - Sopheon

Tue, Aug 4, 2020 by [Jack Brumby](#)

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Buffett calls the distinction between value and growth 'fuzzy thinking' because expected growth is a component of value.

If you think of a stock's intrinsic value as its future cash flows discounted back to the present day at an appropriate rate - tricky to do in practice, but conceptually sound - then some cash-generative, high ROI stocks on a forecast PE of 50x are in fact cheap and undervalued.

It's just that much of the value resides in future cash flows driven by present day investment. This future growth is hard to account for but that creates opportunities. Things seem expensive when they are in fact cheap.

So when should you buy a stock trading on a forecast PE of more than 50?

One possible answer is when you are presented with a scalable small cap software company that is a leader in a large market, with temporarily depressed earnings and strong long term shareholder/manager alignment.

[Sopheon](#) (LON:SPE) could be one such case. The group's shares are down by more than a third from all-time highs over the past year. Co-founder and long time executive chairman Barry Mence retains a large [stake](#) in the company though.

Shareholder	Report date	Holding	Change	% Held
Mence (Barry Keith) Individual Investor	Apr 3, 2020	2.2m	0.0	21.84
Silcock (Stuart Andrew) Individual Investor	Apr 3, 2020	520.3k	0.0	5.10
Universal-Investment-Gesellschaft mbH Investment Advisor/Hedge Fund	Mar 18, 2020	516.7k	0.0	5.06
Berenberg Bank (Asset Management) Bank and Trust	Jul 5, 2019	407.9k	▲407.9k	4.00
Berenberg European Micro Cap Mutual Fund	Dec 31, 2019	523.0k	▲54.3k	5.13

A founder/leader of a small company with a substantial shareholding is not a silver bullet, but that degree of focused management-shareholder alignment is very difficult to replicate at larger companies. It's often a big plus.

Earnings have taken a temporary knock but if they can recover then the group's shares at 870p might be cheap. Recovering to 2018 levels of profitability would imply a 'normal' PE ratio of just over 13x.

That comes with plenty of scope for growth as well, given SPE's market cap of £89m and a growing net cash position on the balance sheet. Everything I've seen so far suggests SPE can increase cash flows and reinvest them back into high return growth projects.

In fact, this is exactly what SPE does for its clients...

What it does

As Bruce Greenwald famously concludes: 'in the long run, everything is a toaster.'

Technological obsolescence and commoditisation are ever present risks in this age, and change is the only constant. SPE specialises in helping clients to optimise their own investments so that they can maintain their competitive edge.



It does so with software such as the regularly updated Accolade system. Its [award-winning](#) products free companies up to better execute on business strategy and improve returns on investments (via optimising things like operational changes, enterprise innovation, product development, supply chain efficiencies and cost reduction).

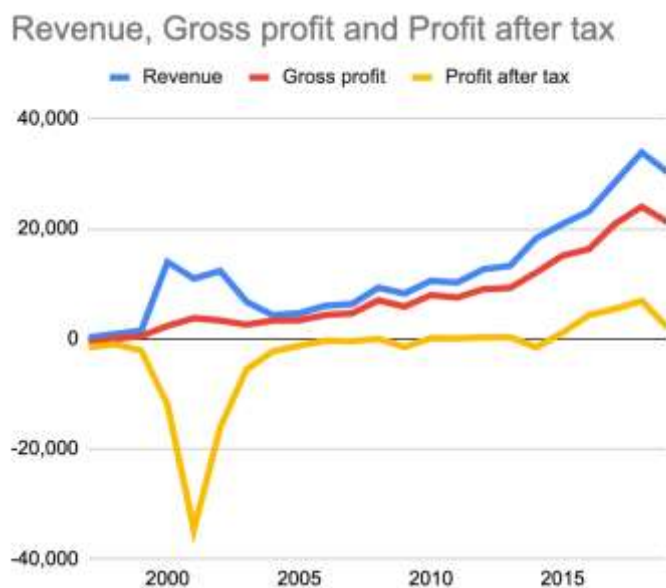


The group has recently broadened its mission to one that helps major enterprises achieve their strategic goals through innovation. This expands SPE's horizons and has become a third major pillar of the enterprise stack, alongside ERP and CRM.

Sopheon has a long history as a software company, stretching back into the 1990s. Back then its main product was Polydoc, which specialised in the development and provision of business solutions in the 'rapidly emerging field of Knowledge Management'.

There have been pivots and acquisitions in the years since but, ably steered by founding member and long time executive chairman Barry Mence, SPE has remained at the forefront of its niche. I believe Mence's stewardship could give SPE an important sense of identity and continuity.

The graph below shows that, barring a couple of poor acquisitions made around the height of the tech boom (with consequent writedowns hitting profits), the story has been one of more or less steady top line growth since the mid-noughties. Through it all, Mence has been at the helm.



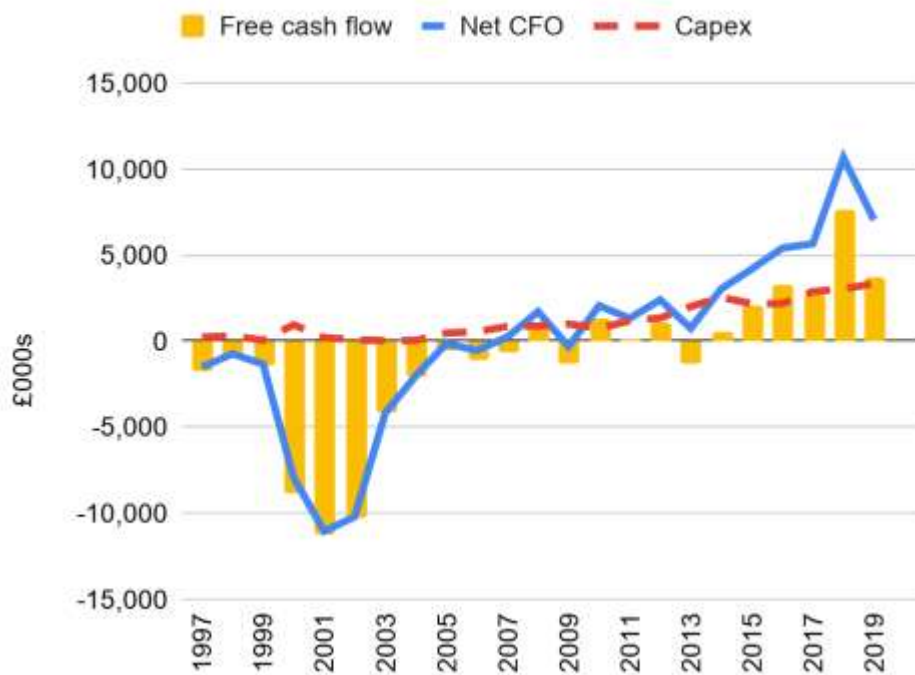
Then of course, there is that dip across the board at the end of the chart... We'll look at what happened in 2019 later. Suffice to say I think SPE is well equipped to recover its trading momentum.

And while the bottom line took a while to lift off, this is more to do with increasing R&D expenditure than a lack of innate profitability. You can see this in the divergence between gross profit and PAT.

A crash course on recent trading

After years of dutiful R&D into its well-regarded products, SPE appears to have struck upon a strategy that realised profits and shareholder value around 2011. While capex has been rising in that period so too have free cash flows.

Net CFO, Capex and Free cash flow



In 2018 SPE generated close to \$8m of free cash flow - not bad for a sub-£100m small cap. If this is an indication of the group's true cash generation potential then that would place SPE on 17.5x free cash flow - a discount compared to other listed software vendors like Dotdigital (c40x) and Cerillion (19.4x). Not only that, I see no reason why free cash flow shouldn't march higher in future with additional business wins.

It has been a bumpy ride up for shareholders though, and the latest twist in the tale came in 2019. A look at the share price chart shows that SPE disappointed the market last year.



This spoils the narrative slightly, but dig a little deeper and you might interpret it as an attractive entry point into a long term growth story. The profit warning really wasn't that bad as far as I can tell.

Here's what management said in the July 2019 [trading update](#):

- H1 2019 revenue was behind at c\$13.7m compared to \$15.9m in 2018, but with a strong pipeline and a 'high probability of closing in the balance of the year'.
- An increasing proportion of opportunities opted for a multi-year, Software-as-a-Service (SaaS) mode, reducing early revenue but paving the way for increasing recurring revenue in future and a greater lifetime revenue from each customer.

The above looks more like a change in client buying habits and more back-end weighted revenue recognition, rather than a material change in underlying commercial momentum.

What's more, trading momentum swiftly recovered. In its recent [AGM update](#), SPE says:

- Momentum rebounded sharply in the final quarter of last year, which was one of the strongest on record for deal flow.
- SPE ended 2019 with a substantially larger sales pipeline, up 50% year on year with a healthy proportion of potential new customers and SaaS business.

Then, on 28 May 2020 in its [Microsoft Teams release update](#):

- Increasing underlying market and commercial momentum.
- Expanded sales resources contributed to a 48 % growth in sales pipeline value between January and June.
- Both the volume of deals and the number of larger deals in the pipeline rose to all-time highs.
- The proportion of SaaS business in the expanded pipeline was also up sharply.

Finally, as if to confirm this healthy trading momentum we have last week's update re. a new [partnership](#) with Mondelez.

This big client win provides further confirmation of SPE's market-leading software. Mondelez will not have made this decision lightly, given the ROI implications. The RNS also makes clear that this is a SaaS implementation, which adds to revenue visibility.

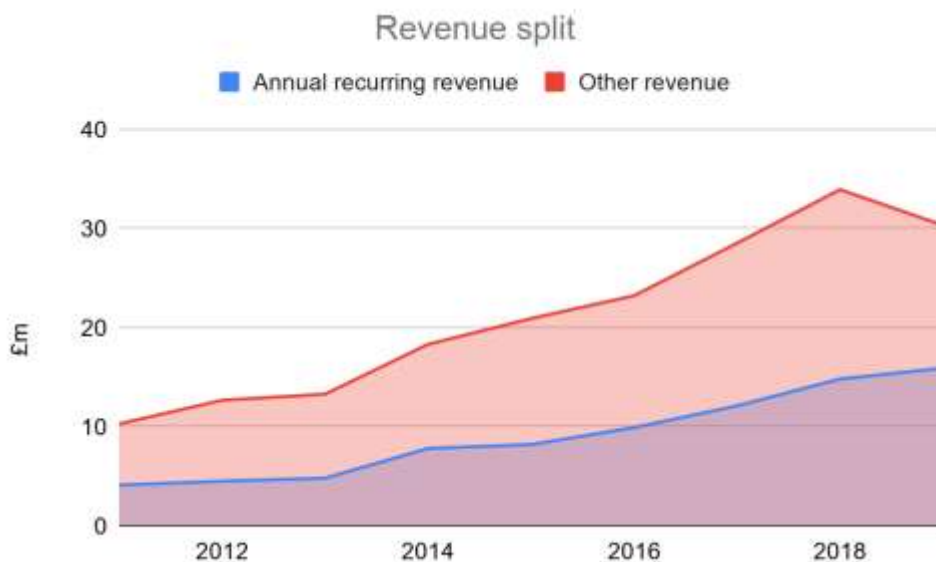
Catalysts

There are a couple of company-specific share price catalysts that could make SPE an attractive investment.

The group's shift to a cloud-based operating model was first flagged in the 2018 annual report. This has since become a key internal driver of change and has allowed SPE to revamp its standard pricing models, service delivery models and commission plans.

Client preference for SaaS should increase lifetime value and also make SPE's trading performance more stable and predictable from one year to the next. This is because a larger proportion of overall revenue and cash flow is recurring. Lower volatility in earnings should make for a more valuable enterprise.

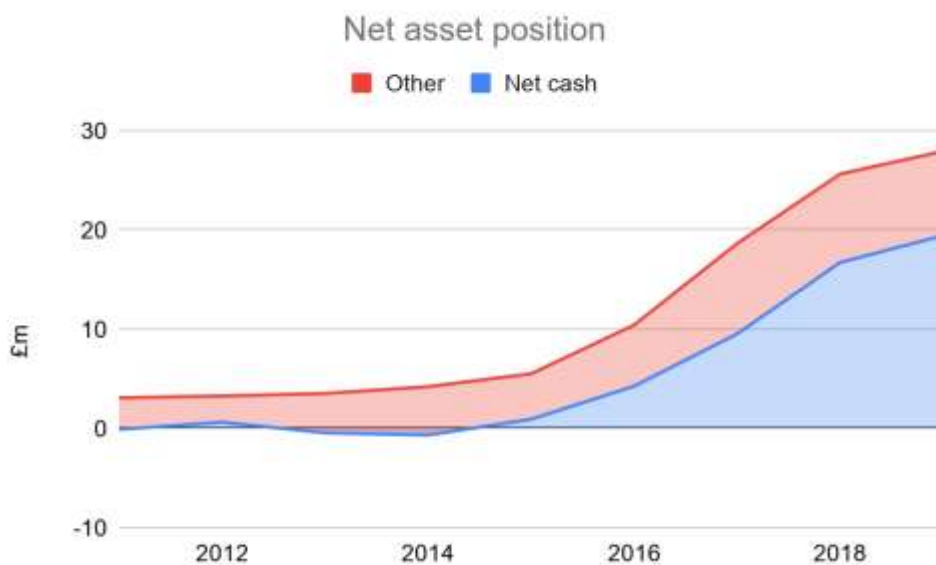
Overall, annual recurring revenue including maintenance and SaaS stood at \$15.9m coming into 2020. This has been increasing rapidly.



SPE has a culture of constant innovation and R&D spend, which helps maintain its powerful market position and builds on its expertise base. The group is responsive and agile, reacting to COVID lockdowns with a 'Disruption Response Toolkit' for its customers and a new Microsoft Teams Connector to reflect new work-from-home habits.

Although 2019 does appear to have been a bump in the road, SPE actually ended it with its strongest quarter on record, with SaaS an ever-increasing proportion of business wins. This healthy underlying trading momentum is a good indicator that SPE's history of spending on R&D is paying off in the form of best-in-class software that is organically attracting heavyweight clients.

This underlying health is also reflected in SPE's record levels of net cash, which drives net asset value ever higher.



Risks

Some risks facing SPE:

Sopheon's markets are emerging and growth may be volatile. As we have seen in 2019, timing and size of sales can have a substantial impact on both trading results and share price performance.

To this point, SPE is a market-leader with a strong balance sheet and a culture of reinvestment into its own products. Its shift to SaaS and its growing recurring revenue base should improve revenue stability and predictability.

Competition. Sopheon is small by global software standards. The group must remain agile, innovative, and customer focused in order to maintain its market position.

Key person risk. Competition for qualified employees is intense and retaining key employees 'has remained challenging'.

Sopheon needs partners to market and implement its products. Historically, Sopheon has devoted substantial resources to the direct marketing of its products. Its strategy to use resellers to widen the customer base is not yet mature.

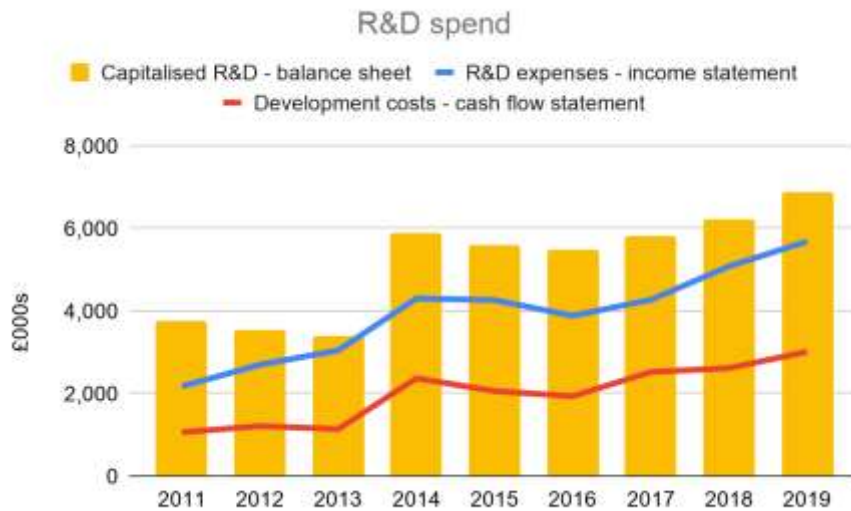
Over the years, Sopheon has built up a network of resellers and consulting partners, however this has yet to mature and the revenues delivered through these relationships remain a relatively modest part of the total.

In my view, this sounds more like an opportunity than a risk.

Conclusion

This one looks interesting.

SPE has led its niche for c20 years and spends millions every year to maintain its strong market position. This R&D investment should drive future profitable growth.



The business model shifts towards SaaS, higher recurring revenues, and cloud-based infrastructure could be attractive company-specific share price catalysts. A predictable and less volatile revenue stream makes for a more valuable business for shareholders.

Yes, SPE underperformed in 2019 but underlying trading momentum seems robust and the recent share price weakness could be a good long term entry point. You can argue that the very reason SPE missed expectations back in 2019 is due to a change in business model that makes the entity more valuable to long term shareholders.

There's no doubt that SPE looks expensive according to conventional metrics but I would argue that there is growth in the pipeline and current figures are temporarily depressed.

Trailing 12m		Industry	Market
PE Ratio (ttm)	59.3	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #d62728;"></div></div>	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #d62728;"></div></div>
PEG Ratio (ttm)	4.55	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #d62728;"></div></div>	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #d62728;"></div></div>
EPS Growth (ttm)	-70.4%	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #d62728;"></div></div>	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #d62728;"></div></div>
Dividend Yield (ttm)	0.38%	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #d62728;"></div></div>	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #d62728;"></div></div>
Valuation (ttm)		Industry	Market
Price to Book Value	4.16	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #ffc107;"></div></div>	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #ffc107;"></div></div>
Price to Tang. Book	5.53	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #ffc107;"></div></div>	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #ffc107;"></div></div>
Price to Free Cashflow	31.4	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #ffc107;"></div></div>	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #ffc107;"></div></div>
Price to Sales	3.84	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #ffc107;"></div></div>	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #ffc107;"></div></div>
EV to EBITDA	16.89	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #ffc107;"></div></div>	<div style="width: 100%; height: 10px; background-color: #ccc; position: relative;"><div style="width: 10%; background-color: #ffc107;"></div></div>

The group's financial health is robust and improving, it is cash generative, and the pipeline is strong.

If SPE can get back to 2018 levels of profitability - which as far as I can tell seems quite likely given the group's operating history, market position, and continued R&D investment - then that would put SPE at 870p on a PE ratio of 13.4x.

What's more, it's entirely possible that SPE surpasses this high water mark and can grow comfortably beyond its current £90m market cap. There are risks of course as with all small caps, so DYOR. What happened in 2019 could happen again, and there is always the risk of a bigger operator coming out with a serious competing product

This hasn't happened yet though (as far as I know) and it looks as though SPE has all the right ingredients to become a significantly larger company in time. As always, interested to hear what others make of this company's prospects.