SMALL CAP SHARE COMMENT
Commissioned Commentary

SANDERSON GROUP (AIM:SND)

Share price 83p

Results in-line, cash still flowing and the dividend up 10%

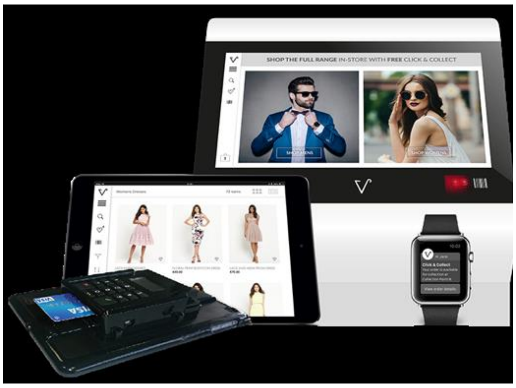
Date: **24th May 2017**
Sector: **Software & Computer Services**
Market Cap: c£46m
www.sanderson.com

The software and IT services business specialising in digital retail technology and enterprise software has a reputation for good shareholder communication and interim results for the 6 months ending 31st March 2017 were predictably in line with the pre-close trading update of 4th May 2017.

- SME sector focus and lots of recurring revenue

Through its different divisions Sanderson Group provides a comprehensive and constantly developing range of modern software solutions, together with associated services to businesses in the multi-channel retail and manufacturing markets, with increasing emphasis on their own proprietary solutions.

The Group's 225 employees address 500 predominantly small and medium sized enterprises and the substantial element of recurring revenue means there is excellent visibility of future earnings.



Emphasis over the past few years has been the development of mobile commerce solutions and food and drink processing solutions. The mobile commerce products, together with in-store technology developments, are collectively referred to as **Digital retail solutions** which enable retailers to capitalise on the huge growth in the widespread adoption of smartphones and tablets and to exploit mobile as a sales channel. Notable success in this area has been achieved with clients JD Sports and Superdry.

With the use of mobile technologies continuing to grow, Sanderson looks well placed to benefit in this area.

- Business segments

Sanderson Group breaks down its results in terms of a **Digital Retail** business division and an **Enterprise Software** division.

The Enterprise software division in turn comprises 2 market-focused businesses which are based on upon the **Manufacturing sector** and the **Wholesale Distribution and Logistics sector**.

- Better balanced order book

The Group order book at 31 March 2017 stood at £2.78m (30 Sept 2016: £3.02m).

Pre-contracted recurring revenues increased to £5.40m (2016: £5.19m) representing 47% of forecast revenue for the 2nd half of the financial year (Broker forecast for the full year ending September 2017 Revenue £22.4m). With the order book at £2.78m this leaves a £3.3m 'Gap' to fill in H2, which looks comfortably achievable.

- Summary results

Income statement

Group revenue for the 6 months increased over 10% £10.90m (2016: £9.86m) with operating profit (before amortisation of acquisition-related intangibles, share-based payment charges and acquisition-related costs) rising to £1.55m (2016: £1.47m).

While gross margin continues to be high at 82% (2016: 86%), it was lower than the comparable period last year, reflecting the initial roll-out and installation of network, communications and hardware infrastructure necessary for the installation of Sanderson solutions at new customer sites. While the hardware element of new installations still achieves attractive margins, clearly these aren't at the same level as pure software sales.

As tax losses have been utilised the tax rate has risen. Substantially all tax losses will have been utilized by the 2017 year end.

Acquisition related costs of £175k relate to costs incurred on an acquisition that ultimately didn't proceed.

Operating expenses increased by approximately £0.55m as Sanderson continued to invest in its management, sales and delivery capacity in expectation of further and continued growth in the digital retail market.

Diluted adjusted earnings per share rose 4.5% to 2.3p (2016:2.2p).

The interim dividend was increased 10% to 1.1p per share (2016:1p) with full year forecasts 2.6p equating to a yield of 3.1% at the current share price.

Balance sheet

The business is highly cash generative. Net cash from operating activities (after the payments to the defined benefit pension scheme) was £1.61m (2016: £1.45m) and year end net cash had risen to £4.51m (2016: £3.39m) representing 8.2p per share.

During the period the Group spent £387k on product development and £134k on capital expenditure.

Total expenditure in Research and Development in the period was £1.65m (Full year 2016: £2.98m) of which £1.27m was expensed and £387k capitalised. This brings total spend in R&D since 2010 to over £14m.

In the period £150k was also invested in the shares of an unlisted company, being a minority stake in a software start-up with some interesting technology.

The pension position remains impacted by the low level of interest rates and the lower discount rate with the deficit at period end £8.1m (2016: £8.1m). The annual funding requirement is currently £360k for the 2017 Financial year. If rates stay depressed, as is likely, the funding requirement will probably rise. However, they would no doubt negotiate, on the bases of the average length of time until members retire as a reason to not increase payments significantly. Notwithstanding, the Group's excellent cash generative abilities would comfortably support this. At the prior year end Pension Scheme assets were approximately £9m and Scheme liabilities £17m, with 70-75 members in the Scheme and the average period until retirement 16 years.

- Board change

Group Finance Director, Adrian Frost, who has been with Sanderson since 2000 and has served as Group Finance Director since 2005 is moving to pastures new and will be leaving the Group during 2017.

His successor has not yet been named.

- Divisional review

Digital Retail
Revenue £3.54m (2016: £2.95m)
Adj. operating profit £340k (2016: £333k)
Order book £0.84m (2016: £0.78m)
60+ customers

The division provides comprehensive solutions for ecommerce, mobile commerce and retail, including cloud-based store solutions.

Mobile enablement and deployment continues to be a key business driver in this market sector with increasing levels of business activity.

The flat operating profits reflect the planned further investment in management, sales and delivery capacity in anticipation of continued growth within the digital retail market.

It was very encouraging to see sales order intake up almost 50% compared with the comparable period last year.

Demand from existing customers for the Group's latest release of its ecommerce solution continued to grow with sales orders gained from a number of customers including Hotel Chocolat and Scotts of Stow.

The mobile solutions business had a busy first half, successfully completing phase two of a European roll-out for Superdry, delivered across eight countries and including major cities such as, Munich, Paris, Brussels, Stockholm and Vienna. The 'connected retail' solution enables Superdry customers to order anywhere, on any device, using any payment method and have their order delivered wherever they choose.

The top 5 customers with a total spend of £2.25m (64% of total) were JD Sports, Superdry, Scotts of Stow, Joe Browns and an unnamed 'Large Retailer'.

Application illustration
Founded in 1979, Life Style Sports is Ireland's largest sports retailer. Life Style wanted to drive more sales in-store whilst enhancing customers' shopping experience.

In response, the Group's One iota business implemented an iPad solution which is carried by sales team members to assist, guide & transact with customers in store. It also helps sell online and extends the ranges in the store thereby driving store sales, boosting average order values and increasing conversions of out-of-stock items.

The result has been an improved sales performance across all Life Style Sports stores.

Application illustration
Kingstown Associates is a leading UK mail order company aimed at the over 60s with 8 lifestyle brands.

It sells through multiple channels encompassing its own websites, Amazon and eBay marketplaces, telesales, orders by post and the factory outlet store.

From its base in East Yorkshire Kingstown also provides fulfilment services to 3rd party clients despatching 1 million parcels a year, 10,000 products and 75,000 catalogues a week.

The company had outgrown its existing systems and wanted a multi-channel retail solution to improve efficiency of overall operations and support its ambitious growth plans.

The business has subsequently benefited from organic business growth of 29%, has doubled online sales in 12 months, and generated an additional £500k revenue via eBay & Amazon. At the operating it has benefited from improved customer service and profitability, faster order to dispatch times and increased order accuracy. It has also been able to respond to sales trends quicker.

Enterprise Division
Revenue £7.36m (2016: £6.92m)
Adj. operating profit £1.21m (2016: £1.15m)
Order book £1.93m (2016: £2.42m)

The Enterprise division comprises two market-focused businesses based upon the ***manufacturing sector*** (the main areas of specialisation being in food and drink, engineering, plastics, aerospace, electronics and print manufacturing) and the ***wholesale distribution and logistics sector***.

Manufacturing sector
Revenue £3.15m (2016: £3.25m)
Adj. operating profit £0.35m (H1 2016: £0.51m)
200+ customers

The manufacturing business gained four new customers during the period (2016: five new customers), including Tomlinsons Dairies Limited, at an average order value of £143,000.

The top 5 customers had a total spend of £716k (23% of total).

Application illustration

Tomlinsons Dairies is a fast growing Welsh dairy business which supplies milk and cream to over 300 outlets across Wales, the Midlands and Northwest England.

The business won major contract to supply Sainsbury's stores in Wales as well as some in England, processing an extra 100 million litres of milk per year.

Tomlinsons patchwork of systems and spreadsheets was not able to support this growth so they called on Sanderson to implement a food and drink ERP system.

The Sanderson implementation reduced the businesses' dependency on spreadsheets and disparate systems.

Wholesale distribution & logistics sector
Revenue £4.1m (2016: £3.66m)
Adj. operating profit £0.86m (2016: £0.63m)
250+ customers

The Group has a strong market position in wholesale and the cash & carry sector where its activities have been augmented by the 2013 and 2014 acquisitions of Priam and Proteus respectively.

Four new customers were gained during the period, including H B Clark & Co and Andertons Music Company. This compares with five new customers in the comparative period of 2016.

Large orders from existing customers included Tottenham Hotspur and Clipper Logistics plc.

The total spend for the top 5 customers was £0.80m (19% of total).

- Broker forecasts

House broker forecasts for the full year ending September 2017 remain for sales of £22.4m (growth 5.2%), normalised adjusted profit before tax of £3.75m, adjusted earnings per share of 5.6p and a dividend of 2.6p, equating to a yield of 3.1% at the current share price.

- Outlook

There was the customary cautious outlook statement from management who commented that while the general economic environment still seems good, there does seem to be a slightly more cautious approach from some customers.

Sales cycles often remain protracted, especially where big projects are being considered especially by larger customers.

confidence that the Group will continue to make further progress and deliver trading results in line with market expectations for the current year ending 30 September 2017.

With a strong net cash position, decent visibility and attractive solutions, notably in digital retail, cash generative Sanderson still looks decent value to us.