

AudioEye is a fast-growing SaaS company that trades at a valuation even making value investors salivate.

The company has been written up by Ares not long ago. The author has done a good job to highlight the growth trend of the company. However, very recently, there has been a selloff (down 20%) due to a short report released by Mariner Research Group. While the report has called many names with checkered histories, We think most of the report is based on cherry-picking and without any merit to form a definitive conclusion.

The selloff provides an attractive entry point for investors to pay only <10x LTM sales for a leader growing at 100+%.

Company Overview

If you are a business owner, you probably don't want to get sued because disabled people cannot access your website. However, to examine and fix your website to comply with the ADA guideline requires extensive knowledge and time; and you probably don't want to do it yourself because the legal cost can be very expensive if you miss a thing or two. If your business is well established, you probably have in-house legal team that can help with interpreting ADA guidelines; but they are not tech savvy enough to monitor and change the website. And good luck getting the legal team and the dev team work together; it will waste a lot of time and money.

AudioEye is the solution that keeps everyone happy, for an affordable price. All you need to do is to install a line of code then the product will show you where to fix so that you can be ADA compliant. And you can choose to fix it on your own or outsource it to AudioEye at a higher price point.

In essence, the company is selling into people's fear and ignorance. According to our conversation with developers, the technology behind is not hard. In fact, many web developers are not even aware of ADA guidelines. So, the company is basically wrapping up their "legal expertise" in a SaaS tech solution. We put legal expertise in quotation marks because ADA guidelines are not mandated by law. Currently, the industry standards are WCAG 2.1 AA standards, which are made by an organization. However, when there's a lawsuit, lawyers and judges look up to WCAG to determine whether the defendant's website is accessible or not.

Since no one really bothers to read through the guidelines and yet the legal cost can be fatal, companies resort to companies like AudioEye to avoid lawsuits. Although there are many competitors out there, none of them matches the size and the success to that of AudioEye. Because this is a nascent industry with a substantial legal white space, many competitors are selling toolbar solutions that will make websites appear to be accessible. However, by just adding a toolbar and options to change the website's fonts and colors only improve the usability of the website in question. Some disabled people need to access websites using external devices like screen readers. To make the content readable to screen readers, developers need to fundamentally fix the codes, not just the appearance.

Thesis I: Sustainable growth with visible margin expansions

AudioEye has been able to grow its MRR at above 100% for several quarters consistently. The driver behind the growth is due to more enterprise clients and more indirect sales to vertical partners who are CMS providers (think Shopify). The recent growth is primarily driven by the latter. The management has decided to focus more on the indirect sales channel to lower the customer acquisition costs while grabbing the user base as quickly as possible. But there's more to it.

We think this is the right strategy to use at this stage. Given the current political climate and the general rise in awareness for minorities, we expect more scrutinies into digital accessibility from the public and the legal community. Unlike a close competitor, AudioEye does not allow customers to white label their solutions. It's not hard to see that the company is trying to reach as many users as possible while retaining the brand recognition.

Since the downside risk from lawsuits can be detrimental to a firm's financial health, companies want to choose a trusted and proven solution, and they are not very price sensitive. We think AudioEye's goal is to become a household name in the industry where companies will only resort to AudioEye's solutions rather than experiment with other cheaper alternatives.

The company can continue its stellar growth rate because this business is very sticky and profitable on a unit economic basis. Although the company does not report LTV/CAC, we find it around 14x by hand calculations. Usually, small SaaS companies with this level of unit economics tend to have a high churn, but AudioEye has been able to maintain an above 90% retention rate (or <1% churn on a monthly basis). This shows 1) the pricing does not appear to be prohibitive to many enterprise clients and 2) customers have a strong incentive to renew because developers rely on AudioEye's alerts to know where the issues are and what to fix. In fact, we believe the number of fixes per period is the North Star metric for this company as it shows how valuable the product is to customers. And it's reasonable to believe this metric continues to be high because as customers grow, they will add and update more webpages, therefore creating more stuff to fix.

The company has been able to sign up and retain blue-chip Logos like Samsung, UBER, ADP, and even regulatory agencies like FCC. Note that companies like Samsung and UBER are not short of tech talents yet they still use AudioEye's solution that, by design, is not very technically sophisticated. This confirms with the point that there are a widespread fear and ignorance among corporations.

In the very recent quarter, the company has achieved a 70% gross margin, up from 54% just a year ago. The improvement is driven by more automation of the remediation process. The company uses a combination of machine learning and hands-on solutions to fix errors. It's worth noting that the company monitors 1 million pages and conduct 1 billion fixes on a daily basis. As the company continues to do this while adding more customers, the machine learning technology will get "smarter" over time, and gradually take over remediation processes that are currently being done by humans.

Another source of margin expansion comes from company's relocation to Portland for its tech team, which will reduce SG&A in long term. However, in upcoming quarters, we expect

margins to contract due to the breakup fees from relocation, lawsuit fees (the company is suing accessiBe for patent infringement), and growth-related expenses like hiring more sales and tech employees—it appears that the company is also expanding geographically as shown by some recent job posts on LinkedIn seeking for sales roles in Canada.

In short, the company can continue its growth and expand its margins as long as fear and ignorance persist. And they will persist because there's very little incentive for companies to move the solution in-house. And laziness is the stickiest habit. That will serve the company very well down the road.

Thesis II: Leadership position to dominate an industry that will be winner-takes-all

The company is the clear leader in a highly fragmented and new industry. As mentioned above, if the company executes on track, it will become the industry standard and will utilize the leadership position to roll up the market.

We think this will eventually be a winner-takes-all or oligopolistic industry because of the amount of experience and expertise required. New players will find it hard to compete, although it's relatively easy for them to enter the market due to the low-tech sophistication. These new players won't have good unit economics because of the prevailing trust issue in this industry—people only want to use trusted and proven solutions, even though that means they pay more. New entrants can only hope to compete by cutting prices, but this is a self-eradicating process for two reasons:

1. They can play with people's ignorance by just offering surface-level solutions like toolbars. But if lawsuits do occur, their reputation and existence will be gone because customers will realize that the solutions don't work. This has happened to accessiBe as lawyers found that websites using accessiBe's solutions are not accessible to screen readers.
2. The strong value proposition comes from the ability to help customers to fix errors. At the early stage, that requires manpower, which will suppress these new players' margins even further. They can try to use AI, but they are already permanently lagged behind AudioEye because of the nature of machine learning requires large and consistent data inputs to improve the accuracy and usability of the technology. And it's expensive. More, since the technology behind is not hard, it's hard for startups to attract VC money to sustain their existence.
 - a. This also explains many existing players out there are created by some university projects rather than for commercial purposes.

More, the company doesn't just sell solutions. It also certifies companies. We can see the company is positioning itself to be the authority in the industry as well. This can be very powerful as the legal environment matures in this industry.

The TAM can be comparatively small to other industries, but We think the growth runway is still long given:

1. The company can upsell to existing customers because the pricing model is based on page views; that means as customers grow, so does their page views, and given the sticky business model, there won't be much headwinds for them to upgrade

2. Cross-sell opportunity exists as the company is leveraging its expertise to offer value-add services like PDF and mobile app remediations. These are priced on a per-project basis but we can see them being bundled into a new pricing class in the future
3. Indirect sales channel will start capturing SMBs operating in niche and consumer-facing industries like automotive, banks, and more. This is something the company is doing differently than its competitors who are only partnering with platforms like Shopify or BigCommerce. Users on those platforms don't really need to worry about the ADA-related lawsuits because they are too small to be required to comply. By partnering with vertical platforms, AudioEye will soon get a larger and diverse customer base that actually pays.

We think going forward, the legal environment will only get stricter on issues like accessibility as more and more businesses become digital. The company will also benefit from this tailwind and is well-positioned to capture the most of it.

Thesis III: Favorable Valuation to both Growth and Value Investors

It's too cheap given the growth and the leadership position. On an NTM basis, the company is only trading at 6x sales. This is a company that grows at 100% and will be cash flow positive in 2021. Alas, due to its small size, its shareholder base is weak as it consists of retail investors who got scared of the short report released not long ago. But as the company continues to grow and the management continues to execute, it will get the media's attention and institutions' interests.

It's worth noting that David Moradi of Sero Capital has taken over the CEO role of the firm. His salary is \$1 per year and the bonus is based on MRR growth and the stock price. He and his fund have the largest ownership of the company (>30%).

The company deserves a rerate to 12x NTM Sales, which is conservative for its growth rate. From the rerate alone, the investment has a ~100% upside. To quantify the downside, we assume a contracted 6.5x sales and no growth for the rest of the year for 2020 revenue, it would indicate a stock price of \$13.57, or a downside of less than 15%.

We think the downside is very limited at current valuation, therefore a very attractive risk-reward ratio.

Risks

- The management fails to execute the pivot to indirect sales channel. This will drastically reduce the MRR as the Logo growth stalls. Direct sales channel is expensive as the company uses field sales strategy to land enterprise customers. However, there's a low probability for this to happen given the CEO has much skin in the game.
- Adverse change in the legal environment that loosens up the requirement for digital accessibility—Highly unlikely.
- The product doesn't prevent customers from lawsuits. This might happen as the ADA guidelines are vague and lack of systemized ways to evaluate websites. However, we think the company's decades-long existence has provided it with adequate experience to different scenarios. In fact, the company is so experienced that it offers legal

protection plans for those got sued. In a new and ambiguous legal environment, whoever establishes authority first tend to be the standard-setter in that space.

Catalysts

Cash flow positive somewhere in 2021

Another quarter of high MRR growth

This second writeup on VIC