

## Salesforce.com, Inc. (CRM)

## Underlying Strength, Especially Ex-FX

**INVESTMENT HIGHLIGHTS:** Q3 was (especially after adjusting for FX impact) highlighted by 28% y/y billings growth (in constant currency), which suggests the health of fundamentals and secular trends. While some might be disappointed by the in-line revenue guide and light F16 rev guide, we're not at all concerned. We believe Salesforce is the highest quality, best-scaled SaaS vendor in our universe leveraged to numerous secular trends, and we appreciate that F16 guidance is prudently conservative, suggesting ample headroom for significant upside revisions especially on the heels of a potentially very strong Q4 (which likely stands to benefit from Dreamforce momentum).

- We're particularly encouraged by record large deal activity (the number of 8-figure deals up 2x y/y), which likely reflects the credibility of the company's industry vertical positioning (rolled out roughly 9 months ago), comprehensive platform strategy, and SI partner ecosystem. We believe the strength of 8-figure deals in 3Q bodes well for 4Q performance, which has historically been even better aligned to EOY and BOY enterprise budget cycles.
- Not surprisingly (and consistent with recent Dreamforce commentary), the hot topic on the call was around recently launched Wave Analytics (next generation, easy to use, mobile-friendly analytic platform for the masses, launched a few weeks ago). Impressively, the product cycle appears to be strong out of the gates (including marquee enterprise wins such as GE, Verizon, and EMC and a ramping partner ecosystem including ISVs and SIs), which suggests another compelling growth driver that could layer onto the model longer term.
- Other highlights included a beat on the top and bottom line despite non-trivial FX headwinds, in-line F15 guidance despite FX headwinds, steady bookings growth (in CC), solid total backlog growth, strength across product areas and geographies and impressive marquee customer wins.
- Management was upbeat on the call, especially with respect to continued momentum coming out of Dreamforce (more than 150K registered, more than 7MM joined online), already impressive uptake from new analytics cloud offering, increased vertical traction, competitive positioning, ramping product cycles and deepening/strategic customer relationships.
- Management guided F15 EPS to \$0.51-0.52 (vs. Street estimate of \$0.51) and CFO to 27-28% y/y growth. Management initiated FY16 revenue guidance of \$6.45-6.50B, which includes roughly \$125-150MM FX headwind.

## ESTIMATE CHANGE

Stock Rating	<b>BUY</b>
	Unchanged
Price Target	<b>\$70.00</b>

## SaaS/Application Software

**Michael Huang**  
(415) 262-4898

mhuang@needhamco.com

**Michael Turrin**  
(415) 262-4897

mturrin@needhamco.com

## Stock Price Performance

Salesforce.com, Inc. 11/20/14



## Market Data

Price (11/19/2014)	\$61.02
52-Week Range	\$67.00 - \$48.18
Shares Outstanding	619.00
Market Cap (MM)	\$37,771.4
Avg. Daily Volume	4,842,490.0
Total Debt/Cap.	37.94%

	FY 01/31/2014		FY 01/31/2015		FY 01/31/2016	
	Actual	Old	New	Old	New	
Rev. (MM)	4,071.0A	5,345.4E	5,367.0E	6,570.4E	6,465.7E	
Growth	33.5%	31.3%	31.8%	22.9%	20.5%	
Op. Margin	8.9%A	10.3%E	10.5%E	11.4%E	11.2%E	
EPS: 1Q	0.10A	0.11A	0.11A	NAE	-	
EPS: 2Q	0.09A	0.13A	0.13A	NAE	-	
EPS: 3Q	0.09A	0.12E	0.14A	NAE	-	
EPS: 4Q	0.07A	0.13E	0.13E	NAE	-	
EPS: Year	0.35A	0.50E	0.52E	0.66E	0.65E	
Growth	(14.6)%	42.9%	48.6%	32.0%	25.0%	
P/E Ratio	NM		NM	92.5x	93.9x	

Relevant disclosures begin on page 5 of this report.

## Summary

Q3 (especially after adjusting for FX impact) was highlighted by 28% y/y billings growth (in constant currency), which suggests the health of fundamentals and secular trends. While some might be disappointed by the in-line revenue guide and light F16 rev guide (initiated rev guidance to \$6.45-6.50B vs. Street consensus of \$6.66B), we're not at all concerned. In our view, Salesforce is the highest quality, best-scaled SaaS vendor in our universe leveraged to numerous secular trends, and we appreciate that F16 guidance is prudently conservative, suggesting ample headroom for significant upside revisions, especially on the heels of a potentially very strong Q4 (which likely stands to benefit from Dreamforce momentum).

We're particularly encouraged by record large deal activity (the number of 8-figure deals up 2x y/y), which likely reflects the credibility of the company's industry vertical positioning (rolled out roughly 9 months ago), comprehensive platform strategy, and SI partner ecosystem. We believe the strength of 8-figure deals in 3Q bodes well for 4Q performance, which has historically been even better aligned to EOY and BOY enterprise budget cycles.

Not surprisingly (and consistent with recent Dreamforce commentary), the hot topic on the call was around recently launched Wave Analytics (next generation, easy to use, mobile-friendly analytic platform for the masses, launched a few weeks ago). Impressively, the product cycle appears to be strong out of the gates (including marquee enterprise wins such as GE, Verizon, and EMC and a ramping partner ecosystem including ISVs and SIs), which suggests another compelling growth driver that could layer onto the model longer term.

Other highlights included a beat on the top and bottom line despite non-trivial FX headwinds (beat Street estimates by \$10 million on the top-line, despite negative FX impact of \$15 million q/q), in-line F15 guidance despite FX headwinds (we estimate additional Q4 impact of \$15 million q/q), impressive bookings growth (billings up 28% y/y in CC vs. up 30% in CC in 2Q15), solid total backlog growth (up 29% y/y in CC vs. up 32% in Q2), strength across product areas (highlighted by Service Cloud revs up 7% q/q, Marketing Cloud revs up 7% q/q and Platform Cloud revs up 6% q/q) and geographies (led by 34% y/y growth in EU and 29% y/y growth in Americas using constant currency) and impressive marquee customer wins (including Archer Daniels Midland, Johnson & Johnson, US Department of Commerce, Barclays, Merck, NBC, and Toyota).

Importantly, we don't detect any meaningful deterioration of sales cycles, close rates, or demand trends across geographies due to macro pressures or to a constrained IT spending environment, which suggests the strength of competitive positioning, the strength of the SaaS secular, the numerous product cycles, the quality of leadership (including new CFO Mark Hawkins, former CFO at Autodesk and VP Finance at Dell), the increasing support of the channel, and the magnitude of opportunity ahead. We continue to believe that Salesforce is the highest quality and best scaled SaaS name in our universe, with numerous product cycles leveraged to the rising strategic importance of SaaS, which certainly suggests favorable risk/reward relative to other sub-scaled, slower growing SaaS names.

Q3 revenue was \$1.38B (up 29% y/y vs. up 38% in Q2 vs. up 37% in Q1 vs. up 37% in Q4 vs. Street target of \$1.37B). EPS was \$0.14 (vs. Street of \$0.13), benefited by the revenue upside and scale economies and likely offset by the impact of Dreamforce (and Connections to a lesser degree). Gross margins compressed to 78.4% (vs. 79.3% in Q2), while operating margins remained flat q/q at 11.0% (vs. up 130 BP in Q2), likely reflecting new international data center roll outs. CFO was \$123 million, down 11% y/y (vs. up 34% in 2Q vs. up 67% in 1Q vs. down 4% in 4Q), impacted by the timing of Dreamforce (Q3 this year vs. Q4 last year). Salesforce added 313 heads in Q3 (vs. 906 in Q2 vs. 927 in Q1 vs. 542 in Q4), bringing total headcount to 15,458.

Management was upbeat on the call, especially with respect to continued momentum coming out of Dreamforce (more than 150K registered, more than 7MM joined online), already impressive uptake from new analytics cloud offering, increased vertical traction, competitive positioning, ramping product cycles and deepening/strategic customer relationships (which is driving increased large deal activity). For FY15, management raised the low-end of revenue guidance by \$25MM to a range of \$5.365-5.37B (vs. previous guidance of \$5.34-5.37B vs. Street estimate of \$5.37B). Management guided F15 EPS to \$0.51-0.52 (vs. previous guidance of \$0.50-0.52 vs. Street estimate of \$0.51) and CFO to 27-28% y/y growth and for operating margins to expand by 125 to 150 bps y/y in F15. For Q4, management guided revenue/EPS to \$1.436-1.441B/\$0.13-0.14 (vs. Street \$1.45 B/\$0.15) assuming a negative \$15 million FX impact q/q. Management initiated FY16 revenue guidance of \$6.45-6.50B, which includes roughly \$125-150MM in FX headwind.

We are revising up our FY15 revenue estimate to \$5.37B (from \$5.35B) and our EPS estimate to \$0.52 (from \$0.50). We are also adjusting our F16 revenue estimate to \$6.47B (from \$6.57B) and our EPS estimate to \$0.65 (from \$0.66) to reflect the newly initiated F16 guidance. At the end of the day, we continue to believe that management's decision to reinvest incremental margin to drive growth opportunities and market share gains next year and beyond makes sense given the predictability and natural leverage of the SaaS model and given key secular trends and competitive leadership.

**Figure 1 Income Statement****salesforce.com, Inc.****Income Statement**

(\$ in thousands, except per share data)

	FYE 2013A	FYE 2014A	2015				FYE 2015E	FYE 2016E
			1QA Apr-14	2QA Jul-14	3QA Oct-14	4QE Jan-15		
<b>Total Subscription &amp; Support</b>	<b>2,868,808</b>	<b>3,824,542</b>	<b>1,147,306</b>	<b>1,232,587</b>	<b>1,288,513</b>	<b>1,340,054</b>	<b>5,008,460</b>	<b>6,043,429</b>
Y/Y % Change	34.9%	33.3%	36.2%	36.5%	28.3%	24.7%	31.0%	20.7%
Q/Q % Change			6.7%	7.4%	4.5%	4.0%		
% Total Rev	94.1%	93.9%	93.5%	93.5%	93.1%	93.2%	93.3%	93.5%
Services Revenue	181,387	246,461	79,466	85,964	95,142	97,996	358,568	422,279
Y/Y % Change	29.3%	35.9%	57.6%	58.5%	33.0%	39.5%	45.5%	17.8%
Q/Q % Change			13.1%	8.2%	10.7%	3.0%		
<b>Total Revenues</b>	<b>3,050,195</b>	<b>4,071,003</b>	<b>1,226,772</b>	<b>1,318,551</b>	<b>1,383,655</b>	<b>1,438,050</b>	<b>5,367,028</b>	<b>6,465,708</b>
Y/Y % Change	34.6%	33.5%	37.4%	37.8%	28.6%	25.6%	31.8%	20.5%
Q/Q % Change			7.1%	7.5%	4.9%	3.9%		
<b>Cost of Revenues</b>								
Cost of Subscription	383,181	556,916	168,465	184,670	204,277	195,648	753,060	872,738
Gross Margin	86.6%	85.4%	85.3%	85.0%	84.1%	85.4%	85.0%	85.6%
Cost of Services	189,392	256,548	83,358	88,913	94,465	97,299	364,035	419,274
Gross Margin	-4.4%	-4.1%	-4.9%	-3.4%	0.7%	0.7%	-1.5%	0.7%
Total Cost Of Revenues	572,573	813,464	251,823	273,583	298,742	292,947	1,117,095	1,292,012
<b>Adjusted Gross Profit</b>	<b>2,477,622</b>	<b>3,257,539</b>	<b>974,949</b>	<b>1,044,968</b>	<b>1,084,913</b>	<b>1,145,103</b>	<b>4,249,933</b>	<b>5,173,696</b>
Total Gross Margin	81.2%	80.0%	79.5%	79.3%	78.4%	79.6%	79.2%	80.0%
<b>Operating Expense</b>								
Sales and Marketing	1,403,820	1,872,382	557,257	586,825	621,656	655,751	2,421,489	2,929,980
% of Revenues	46.0%	46.0%	45.4%	44.5%	44.9%	45.6%	45.1%	45.3%
Y/Y % Change	34.1%	33.4%	37.9%	39.7%	26.2%	18.1%	29.3%	21.0%
Research and Development	353,146	516,378	161,074	169,997	168,592	184,070	683,733	810,902
% of Revenues	11.6%	12.7%	13.1%	12.9%	12.2%	12.8%	12.7%	12.5%
General and Administrative	363,845	505,038	137,230	143,250	141,801	158,185	580,466	708,772
% of Revenues	11.9%	12.4%	11.2%	10.9%	10.2%	11.0%	10.8%	11.0%
<b>Total Adjusted Operating Expenses</b>	<b>2,120,811</b>	<b>2,893,798</b>	<b>855,561</b>	<b>900,072</b>	<b>932,049</b>	<b>998,007</b>	<b>3,685,689</b>	<b>4,449,653</b>
<b>Adjusted Operating Income</b>	<b>356,811</b>	<b>363,741</b>	<b>119,388</b>	<b>144,896</b>	<b>152,864</b>	<b>147,096</b>	<b>564,244</b>	<b>724,043</b>
Operating Margin	11.7%	8.9%	9.7%	11.0%	11.0%	10.2%	10.5%	11.2%
Y/Y % Change	36.5%	1.9%	27.1%	48.4%	65.0%	85.1%	55.1%	28.3%
Non-Cash Items / Other/Stock Comp	491,358	671,407	174,729	178,330	174,906	186,000	713,965	792,000
<b>Reported Operating Inc.(Loss)</b>	<b>(134,547)</b>	<b>(307,666)</b>	<b>(55,341)</b>	<b>(33,434)</b>	<b>(22,042)</b>	<b>(38,904)</b>	<b>(149,721)</b>	<b>(67,957)</b>
Operating Margin	-4.4%	-7.6%	-4.5%	-2.5%	-1.6%	-2.7%	-2.8%	-1.1%
Y/Y % Change	183.7%	128.7%	2.9%	-36.0%	-77.5%	-62.5%	-51.3%	-54.6%
Total NonGAAP Other Income	6,753	(24,919)	(9,915)	(9,958)	(5,455)	(5,378)	(30,706)	(21,512)
GAAP Amortization of Debt Discount		(25,350)	(10,984)	(9,216)	(8,638)	(8,000)	(36,838)	(32,000)
Gain on sales of land/building improvements					15,625		15,625	
Loss on Conversion of Note			(8,529)	(361)	(1,339)		(10,229)	
Adj. Income Before Taxes	363,564	338,822	109,473	134,938	147,409	141,718	533,538	702,531
Adj Provision for Taxes	121,021	116,969	39,957	49,253	53,804	51,727	194,741	256,424
Tax Rate	33.3%	34.5%	36.5%	36.5%	36.5%	36.5%	36.5%	36.5%
Reported Income Before Taxes	(127,794)	(357,935)	(84,769)	(52,969)	(21,849)	(52,282)	(211,869)	(121,469)
Rep Provision for Taxes	142,651	(125,760)	12,142	8,119	17,075	12,548	49,884	29,153
Tax Rate	112%	-35%	14%	15%	30%	24%	24%	24%
Consolidated Net Income	<b>(270,445)</b>	<b>(232,175)</b>	<b>(96,911)</b>	<b>(61,088)</b>	<b>(38,924)</b>	<b>(64,829)</b>	<b>(261,752)</b>	<b>(150,622)</b>
Minority Interest	-	-	-	-	-	-	-	-
Quarterly Change in Valuation Allowance	-	-	-	-	-	-	-	-
<b>Adjusted Net Income</b>	<b>242,543</b>	<b>221,853</b>	<b>69,516</b>	<b>85,685</b>	<b>93,605</b>	<b>89,991</b>	<b>338,797</b>	<b>446,107</b>
Profit Margin	8%	5%	6%	6%	7%	6%	6%	7%
Y/Y % Change	25%	-9%	14%	52%	62%	92%	53%	32%
<b>Reported Net Income</b>	<b>(270,445)</b>	<b>(232,175)</b>	<b>(96,911)</b>	<b>(61,088)</b>	<b>(38,924)</b>	<b>(64,829)</b>	<b>(261,752)</b>	<b>(150,622)</b>
<b>Adj. EPS - Diluted</b>	<b>0.41</b>	<b>0.35</b>	<b>0.11</b>	<b>0.13</b>	<b>0.14</b>	<b>0.13</b>	<b>0.52</b>	<b>0.65</b>
Y/Y % Change	-70.1%	-14.2%	9.6%	46.8%	57.9%	86.2%	47.7%	25.8%
Reported EPS - Basic	\$ (1.92)	\$ (0.39)	\$ (0.16)	\$ (0.10)	\$ (0.06)	\$ (0.10)	\$ (0.42)	\$ (0.23)
Diluted Shares Outstanding (in millions)	595.5	634.5	648.0	647.8	658.5	669.0	655.8	686.5

Source: Company Reports and Needham Estimates

Michael Huang

415.262.4898

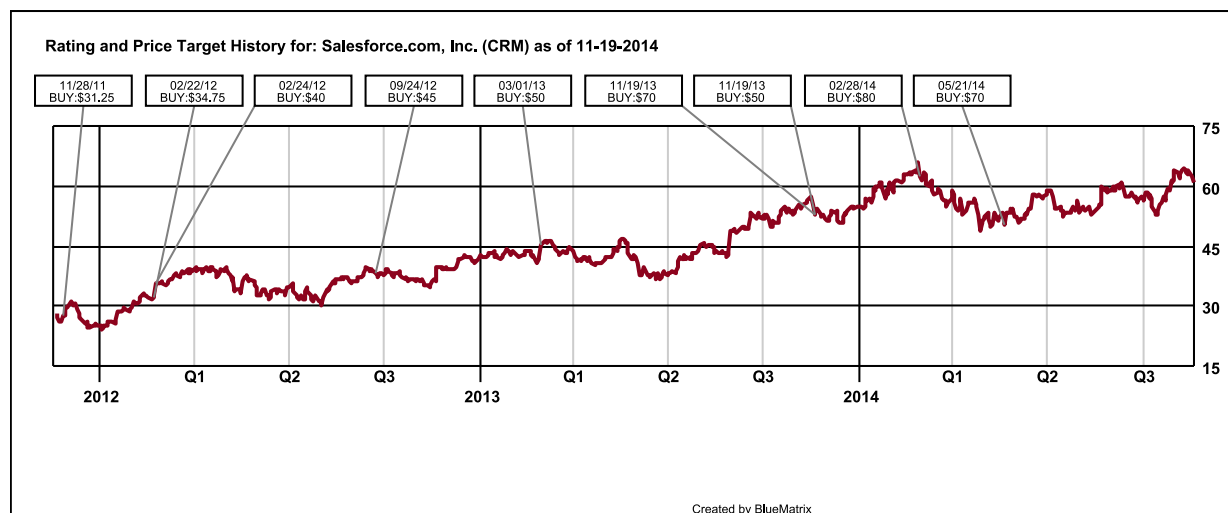
Source: Company Reports and Needham &amp; Company, LLC estimates

### Valuation (Price Target: \$70.00)

CRM shares trade at 6.1x EV/CY15Revs, but support a more premium multiple in our view given the company is the best scaled, highest quality SaaS name in our universe. We're maintaining our price target of \$70, predicated on 7x EV/CY15Revs, which we believe is reasonable for the top-shelf SaaS name in our universe with significant growth drivers and strengthening competitive positioning ahead.

### Risks to Target

Risks: 1) Macroeconomic weakness could weaken renewals and delay sales cycles; 2) Increasing competition could impact new and renewal pricing; 3) Recent acquisitions could distract management and impact execution around core business; 4) Unknown adoption rates of new products.



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