

## Datadog Inc. (DDOG): Breaking the silos between DevSecOps to build a unified platform - Analyst Day Takeaways

We reiterate our Buy rating and 12-month price target of \$188 following Datadog's Analyst Day. As an end-to-end DevSecOps platform Datadog is a strategic infrastructure software company poised to benefit from customers' cloud migrations and digital transformation. At a runrate of ~\$1.6bn the company is single digit penetrated in a large underpenetrated TAM of \$62bn. The announcement of several new products in cloud monitoring, application security monitoring and shift left observability modules further strengthen the platform making Datadog a formidable competitor, with the advantage of an integrated platform solution. This coupled with a solid profitable business model that generates rising FCF margins alongside hyper-growth, Datadog is poised to grow into a preeminent infrastructure software business, in our view. Given the increasing probability of a recession in CY23, we highlight how Datadog is uniquely positioned to play both defense in a downturn and offense in a recovery. At ~11x FY23 EV/Sales, growing 44% y/y and FCF margins of 21% y/y Datadog trades at attractive levels (EV/S/G of 0.2x vs coverage at 0.4x).

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### Key takeaways from the Analyst Day

#### New product releases bolster product portfolio further strengthening

**Datadog's E2E DevSecOps platform.** Datadog hosted in-person 'Dash 2022', the company's annual user conference. Keeping true to the mission of being an end-to-end platform for all things observability and security the company made several product announcements today. The new product announcements were focused on enhanced cloud monitoring, application security monitoring, shift left (particularly in the testing phase) and breaking down silos between DevOps and security teams. We highlight some key product announcements below.

- **Cloud Cost Management:** provides visibility into cloud costs by giving managers a breakdown of cloud spending by team, service, and application. This tool is critical in helping teams optimize cloud spending and maximize efficiency.
- **Continuous Testing and Intelligent Test Runner:** as part of the 'Shift Left' strategy, the company announced new products to run end-to-end tests in the early stages of the development cycle. Production and testing times for modern applications are complex and time-consuming. Datadog's Continuous testing products enable engineers to run tests faster, reduce bugs and increase time to release.

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- **Cloud Security Management:** breaks down the silos between DevOps and Security teams by providing a single platform to detect threats, remediate incidents and secure cloud applications.

**Channel checks indicate cautious demand environment, yet healthy pipeline for Datadog products.** Conversations with partners echoes 2Q commentary. We spoke with a number of partners at Datadog's annual user conference (Dash), which provided us with a gauge on the current demand environment and the company's positioning within its core observability market. We highlight the following key takeaways: **1)** Datadog is becoming an increasing proportion of its customers' IT budgets, namely due to custom integrations and its consumption-oriented model, the latter of which can result in costs quickly scaling out due to high amounts of data ingestion. However, partners also highlight Datadog's price/performance advantage relative to peers such as Splunk, New Relic, Elastic and Dynatrace. We believe this is validation of Datadog's best-in-class platform suite, which in turn makes the company's solutions stickier even as budgets face more scrutiny in a downturn (we highlight the company's high-90% retention rates for enterprise customers and mid-90% for SMB). **2)** Datadog is still levered to a significant greenfield opportunity in observability, benefiting from the accelerated deployment of cloud-native applications while also seeing healthy displacement opportunities (notables included Dynatrace, New Relic, Elastic). **3)** Partners see increasing evidence of platform standardization on Datadog due to its cloud-native architecture and superior performance, but a lack of enterprise and workforce education/readiness suggests fragmentation will persist shorter-term. **4)** Lead-generation and top-of-funnel activity is trending solid despite the current macro-environment, though deals are seeing more scrutiny than in the prior 12-months (consistent with counterparts, per 2Q results) and a handful of mid-market companies are delaying purchases/implementations. Based on our conversations, we did not get the sense that the new business environment had weakened materially vs. management's commentary during 2Q, but rather reflects what has been a more cautious purchasing environment due to the potential for a protracted downturn that could extend into 2023. We note that Datadog saw a meaningful deceleration in cRPO growth to ~50% in 2Q vs. 85% in 1Q, citing lower upfront commitments from customers due to an uncertain environment (this aligns with higher deal scrutiny, more cautious buying behavior from our conversations).

**Analyst Day announcements resonate with our LT thesis on Datadog.** We believe Datadog is uniquely positioned to benefit from multiple growth vectors including, long-term secular shift to the public cloud, growing product portfolio and expanding market opportunity beyond observability. According to Gartner by 2026 cloud spending is expected to reach \$1tn or ~17% of total IT spending, we view this as a strong secular tailwind for Datadog's platform which addresses critical aspects of customer's cloud migration. As IT departments shift usage from multiple point solutions into a single integrated suite, Datadog's robust product portfolio packaged into a unified platform is poised to capture strong market share in the ~\$62bn observability market. With a long runway to grow, the company operates at the Rule of 89 in F2Q22 through a combination of 74% revenue growth and 15% FCF margins, well above the peer average at the Rule of 40. Our long-term thesis on Datadog was reinforced during the

Analyst Day, and we believe the stock is well positioned to navigate a downturn along with upside potential in a recovery. In our recent industry [note](#) we highlight characteristics that make for quality recession resilient stocks, we believe Datadog ranks well across several metrics. Having a predominantly **organic product-led growth strategy** has enabled the company to be efficient, which augurs well for the **longer-term margin and cash flow** structure without compromising growth. A strong engineering-focused culture has resulted in a cohesive product suite that is increasingly finding traction with large enterprises while the **economics of customer acquisition continue to get more attractive** (S&M efficiency of 0.6x). Our channel checks validate the mission criticality and **high customer retention rates** (more below). However, we acknowledge that in an economic downturn investor sentiment around consumption models have been skeptical. We detail in our GS conference [takeaway notes](#) the unique nature of Datadog's business model, which has the cushion of a ratable subscription model from upfront committed credits and consumption variability from on demand purchases. Owing to the sticky nature of the platform, healthy unit economics and a recurring revenue component we believe the business model is insulated during a slowdown. In an economic upturn as customers increase spending on cloud transformational projects, we believe the recovery in consumption trends will result in revenue reacceleration. At current levels, we believe Datadog trades at attractive levels of ~11x FY23 EV/Sales, growing 44% y/y and FCF margins of 21% y/y versus software coverage of ~6.4x EV/Sales, 23% revenue growth and 14.7% FCF margins. (EV/Sales/Growth: DDOG 0.2x vs peers 0.4x)

### Our Thesis on Datadog

We believe that Datadog is a strategic infrastructure software provider with its end-to-end observability platform poised to benefit from IT departments shifting usage from multiple point solutions into an integrated suite. Datadog's product-led and grass roots GTM engine coupled with best-in-class technology stack is resonating increasingly well with customers. Furthermore, with its upmarket motion gaining traction, highlighted by ~54% growth in \$100K customers, we believe the company is positioned for many years of durable revenue growth. With a ~\$1.6bn revenue run rate vs a \$50bn+ addressable market (\$20bn APM/infrastructure + parts of security + parts of digital engagement), we see substantial runway ahead. Datadog is a unique software asset in that it is one of the very few business models that is operating at the Rule of 89 in 2Q22 through a combination of 74% revs growth and 15% FCF margins, well above the peer average at the Rule of 40. Based on the strength of its expanding product portfolio that addresses critical aspects of customers' cloud migration, coupled with a solidly profitable business model that generates rising FCF margins alongside hyper-growth, Datadog is poised to grow into a preeminent infrastructure software business.

### Datadog through the lens of the GS Framework for Investing in Software

Datadog maps well in our GS Software Framework with a large and expanding, yet under penetrated TAM that we size at ~\$50bn, a solid long-term framework and multiple durable secular themes. In our view, Datadog is very well positioned to capitalize on organizations' need for end-to-end monitoring amid the increasing complexity of IT stacks as they undergo Digital Transformations, shift workloads to the cloud, and

increase data volumes. Competitively, while Datadog faces competition across the Observability market including from Splunk, Elastic, and Dynatrace, we believe the company has a solid track record of technology innovation, a strong core monitoring portfolio, and levers to drive upsell and cross-sell through its large installed base.

#### Exhibit 1: DDOG through the lens of our framework for investing in software

OUR VIEW ON DATADOG		
8 KEY FACTORS	TANGIBLE	INTANGIBLE
TAM	Large TAM - \$50bn+ Upsell potential - ~79% customers using 2+ products, ~37% using 4+	Expanding use cases in Security, APM, Synthetics, RUM, AIOps, Logs Opportunity to move higher into enterprise market
SECULAR THEMES	Digital Transformation, Observability, APM, DevOps, AI Security and resiliency a top CIO priority	Complexity of hybrid/multi cloud, containers create demand Strong position with IT teams, moving beyond IT/engineering
ENTRY/EXIT POINTS	Stock trades at a premium to peers, justified given higher growth	Pent-up observability demand in near-term Potential upside to C22/C23 revs
LT FRAMEWORK RETURN	Compounded return: Bear case: 13%; Base case: 22%; Upside: 38%	Market penetration in the low-to-mid single digits Believe company can sustain 40% revs + 20% FCF margins in long-term
UNIT ECONOMICS	Operates above the rule of 80+, with accelerating revenue growth 130% dollar-based retention rate	Upsell of ancillary products drive higher ARR per customer Efficient go-to-market engine with clear pricing, frictionless onboarding
PLATFORM/ BEST OF BREED	Best-of-breed infrastructure monitoring offering with shift into APM, DEM, AI, Security, Analytics	Improving gross retention rates point to potential vendor lock-in Increasing ARR mix of \$100K+ customers points to upmarket momentum
COMPETITIVE MOAT	Technology moat with differentiated/scalable infrastructure monitoring Network effects drive increased usage and expansion	Competition with DT, ESTC, SPLK, NEWR, SUMO, CRWD
ESG	Cloud adoption should drive customers to cloud-native monitoring tools	Increase in operational efficiency, employee productivity

Source: Company data, Goldman Sachs Global Investment Research

### Valuation & Key Risks

We maintain our 12-month price target of \$188. Our price target is based on a 50%/50% weighting of EV/Sales and DCF. We use an EV/SNTM Sales multiple of 20x (unchanged), and our 20-year DCF assumes a perpetuity growth rate of 3% (unchanged).

Key downside risks include: 1) Decline in sales growth from lower SMB contribution resulting from COVID-19, 2) Declining sales productivity, 3) Increased competition from both observability and hyperscaler providers, 4) Lack of traction of newer products, and 5) Ramp to target operating model.

DDOG

12m Price Target: **\$188.00**Price: **\$79.00**Upside: **138.0%**Buy **CL**

## GS Forecast

Market cap: \$27.2bn  
 Enterprise value: \$26.2bn  
 3m ADTV: \$418.0mn  
 United States  
 Americas Software  
 M&A Rank: 3  
 Americas Conviction List

	12/21	12/22E	12/23E	12/24E
Revenue (\$ mn)	1,028.8	1,669.3	2,403.9	3,355.5
EBITDA (\$ mn)	188.0	311.4	466.7	670.1
EBIT (\$ mn)	165.1	279.9	426.3	614.3
EPS (\$)	(0.07)	(0.23)	(0.37)	(0.59)
P/E (X)	NM	NM	NM	NM
EV/EBITDA (X)	194.7	76.9	52.4	37.2
FCF yield (%)	0.7	1.4	1.9	2.4
Dividend yield (%)	0.0	0.0	0.0	0.0
Net debt/EBITDA (X)	(4.4)	(3.5)	(3.3)	(3.2)

	6/22	9/22E	12/22E	3/23E
EPS (\$)	(0.02)	(0.09)	(0.17)	(0.04)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 19 Oct 2022 close.

# Disclosure Appendix

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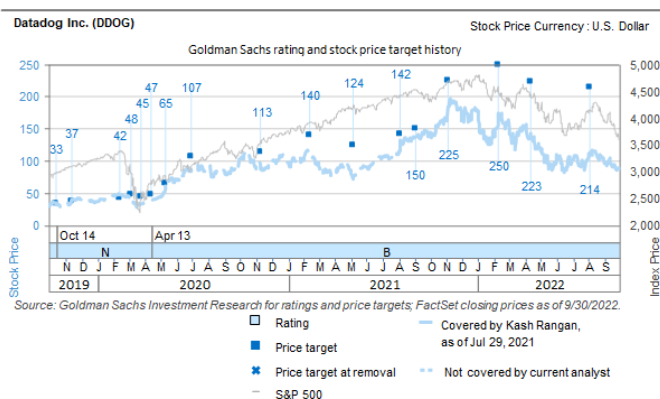
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