

VMware Inc (NYSE: VMW) - BUY

Philip Song
(617) 777 4384
philipssong@gmail.com

Recommendation:

I recommend a long position on VMware Inc (VMW) with a 2022 Q1 price target of \$206, offering 52.7% upside from a current price of \$134 and an IRR of 24% over a two year holding period. I believe that VMware has 1) product leadership in a concentrated market with leading customer retention and ROIC, 2) the ability to diversify and grow revenue ~19% per year over the next 4 years by capturing growth opportunities in key nascent trends, and 3) an attractive buy-in opportunity due to misplaced market pessimism.

Business Description:

VMware develops cloud computing and machine virtualization software and services for enterprise IT markets. Virtualization is a process that runs a virtual instance of a computer system in a layer abstracted from actual hardware, allowing multiple operating systems to run on a single physical server. Hybrid cloud computing refers to an environment in which enterprises can run workloads on a single infrastructure that connects the company's on-prem private cloud and a third-party public cloud.

Investment Thesis:

1. Product leadership in a market at capacity yields industry-leading customer stickiness and ROIC

VMware is the winner and dominant vendor in machine virtualization software, owning 60%-75% market share in an increasingly concentrated market. Customer retention remains high at ~92% and has increased steadily over time, protected by high switching costs for IT professionals and cross-selling between VMware's virtual storage, security, and routing product lines. VMware offers highly recurring revenue and the consistently highest ROIC (currently 62%) in its comparable company group. Smaller open-source alternatives lack the features and UI to meaningfully poach incumbent VMware users.

2. VMW can grow revenue ~19% per year over the next 4 years by capturing growth opportunities in key nascent trends

I identify attractive sustainable growth opportunities in three adjacent markets: hybrid cloud solutions, hyper-converged infrastructures (HCI), and network virtualization. The market for hybrid cloud solutions and HCI is expected to grow at 17% CAGR over the next 4 years as enterprises increasingly integrate on-prem networks with public clouds. The market for network virtualization solutions is expected to grow at 22.9% CAGR over the next 4 years as network traffic rises. VMware is in a unique position in which it can leverage its massive cloud provider program (>1000 partners) and the structural commonalities between these new offerings and its existing product entrenchment to capture new growth. Using a blended market growth rate across different business segments, I believe VMW can achieve a ~19% growth rate over the next 4 years.

3. Misplaced market pessimism allows for a cheap buy-in opportunity

Post-Covid market cynicism has lowered VMW revenue growth and earnings expectations. While Covid disruptions will cause a contraction of economic demand, I anticipate that this will be partially offset by an increased demand for distributed cloud IT systems resulting from a loss of on-prem capabilities amidst lockdown orders. VMware also continues to enjoy a strong liquidity position, and I anticipate the P/S multiple to re-rate to historical levels when VMW announces relatively unchanged revenues and customer retention rates in the following quarters.

Valuation:

I am valuing the company assuming a two year holding period. In a base case, I assume the P/S multiple will re-rate to the level prior to Covid-19 shocks at 7.9x and drive sales revenue of \$26.5/share, offering 55% upside potential. In a bull case, I assume P/S will re-rate to a 2-year forward multiple of 10x and drive sales of \$27.8/share. In a bear case, I assume the multiple will not re-rate and remain at the current level of 5.3x, driving sales of \$24/share. At probability weights of 50% for the base and weights of 25% for the bull and bear cases, I arrived at a FY22 target price of \$206, which implies a 24% IRR and 52.7% upside. As a sanity check, a DCF analysis assuming 7.8% cost of capital and 3% perpetual growth yields a price range similar to that of a multiples-based approach.

Risks:

- **Competition in nascent markets:** High switching costs, long onboarding cycles, and established domain expertise for machine virtualization should favor adjacent cross-selling opportunities into VMW hybrid cloud solutions.
- **DELL controlling ownership:** Management expects to realize \$1 billion in annual synergies with Dell by preloading VMW software on Dell hardware and marketing collaboration.

Catalysts:

- Q3 and Q4 earnings releases will beat consensus and correct market misconception.
- Perceived increased need for cloud solutions and digital transformation initiatives after Covid-19.

Capitalization		Key Stats	
Share Price	\$134.9	52 Week High	\$206.8
Shares Outstanding (\$m)	425	52 Week Low	\$87.8
Market Cap	\$57,315.5	FY20 EV/EBITDA	24.4
Cash & Equivalents (%)	11.1	FY20 P/E	8.9
Total Debt	73.3	2 Year Target Price	\$205.8
EV (\$b)	\$60.0	IRR	24%

	Base	Bull	Bear
FY22 Sales/Share	\$26.5	\$27.8	\$24.0
P/S Multiple	7.9x	10x	5.3x
Implied share price	\$209.3	\$278.0	\$127.2
IRR	24.80%	44%	-2.60%
DCF implied price	\$218.7	\$269.4	\$194.2
Weighted average share price	\$205.8		
IRR	24%		