

## SALESFORCE.COM, INC (CRM)

### Information Technology – Enterprise Management Software

Apr 19, 2021

#### Investment Thesis

Salesforce.com, inc. delivers cloud-based customer relationship management software in the global market. It operates through Subscription & Support and Professional Services & Other two departments. The 20.4% CAGR in the most recent five years indicates that it is still at the growth stage of the business life cycle.<sup>1</sup> The frequent M&A and strategic investment activities accelerated its expansion. As of April 19, 2021, our target price implies a 13-17% upside. Therefore, we recommend a BUY rating.

#### Drivers of Thesis

- The total revenues increased by 24% during the pandemic. We estimate it to grow by 21% in 2021, gradually slow down and stabilize around 6% in the long run, which outpaces the 11.18% industry sales growth rate.<sup>1</sup>
- Salesforce supplies services and solutions for different size consumers in almost every industry all over the world. None of the clients attributed to more than 5% of the total revenues.<sup>1</sup>

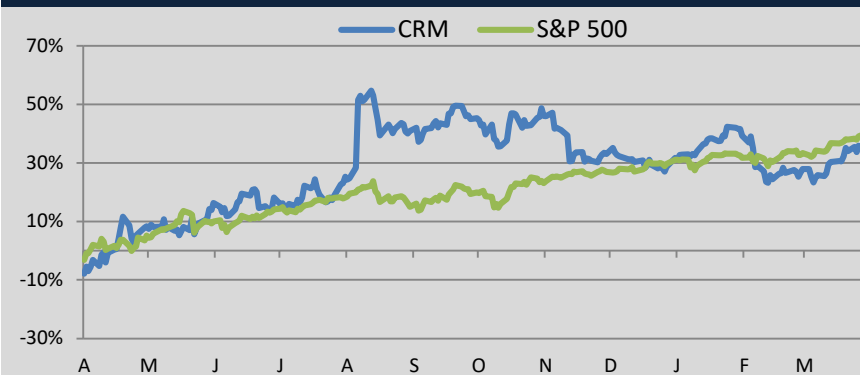
#### Risks to Thesis

- Salesforce is less diversified as compared to peers, it only operates in three market sectors and relies heavily on Customer Relationship Management related products.<sup>8</sup>
- The Enterprise Management Software industry has low entry barriers so that more and more small to medium-size competitors entered the market. Market leaders like Salesforce are forced to expand by acquisition and investments, which are costly in the long run.<sup>14</sup>

#### Earnings Estimates

| Year    | 2019   | 2020   | 2021    | 2022E  | 2023E  | 2024E  |
|---------|--------|--------|---------|--------|--------|--------|
| EPS     | \$1.48 | \$0.15 | \$4.48  | \$3.44 | \$4.15 | \$5.12 |
| HF est. | -      | -      | -       | \$3.26 | \$4.08 | \$4.79 |
| growth  | 722.2% | -89.9% | 2886.7% | -27.3% | 25.2%  | 17.5%  |

#### 12 Month Performance



Source: Yahoo! Finance<sup>15</sup>

#### Stock Rating

BUY

#### Target Price

\$260-270

|                       |       |
|-----------------------|-------|
| Henry Fund DCF        | \$265 |
| Relative Multiple P/E | \$80  |
| Relative Multiple P/S | \$196 |

#### Price Data

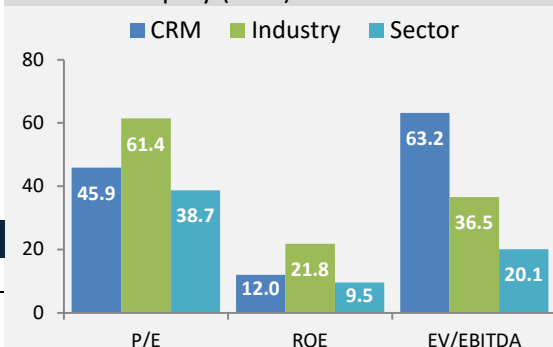
|                      |             |
|----------------------|-------------|
| Current Price        | \$231       |
| 52wk Range           | \$138 – 285 |
| Consensus 1yr Target | \$274       |

#### Key Statistics

|                         |         |
|-------------------------|---------|
| Market Cap (B)          | \$203.6 |
| Shares Outstanding (M)  | \$921.0 |
| Institutional Ownership | 81.8%   |
| 5-yr Monthly Raw Beta   | 1.1     |
| Dividend Yield          | 0.0%    |
| Est. 5yr Growth         | 14.3%   |
| Price/Earnings (TTM)    | 45.9    |
| Price/Earnings (FY1)    | 64.2    |
| Price/Sales (TTM)       | 9.9     |
| Price/Sales (FY1)       | 7.9     |

#### Profitability

|                        |       |
|------------------------|-------|
| Operating Margin       | 2.1%  |
| Profit Margin          | 74.4% |
| Return on Assets (TTM) | 7.4%  |
| Return on Equity (TTM) | 12.0% |



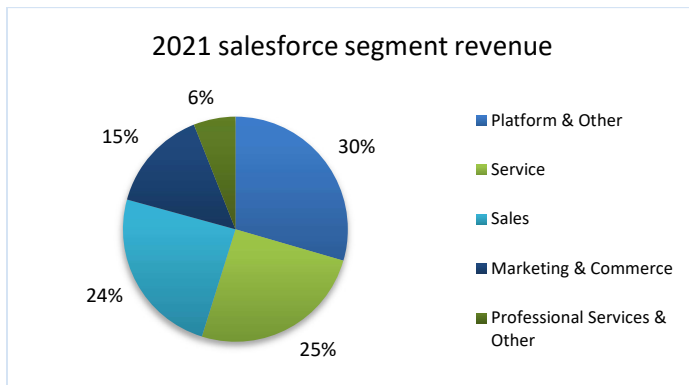
Source: FactSet & Bloomberg

#### Company Description

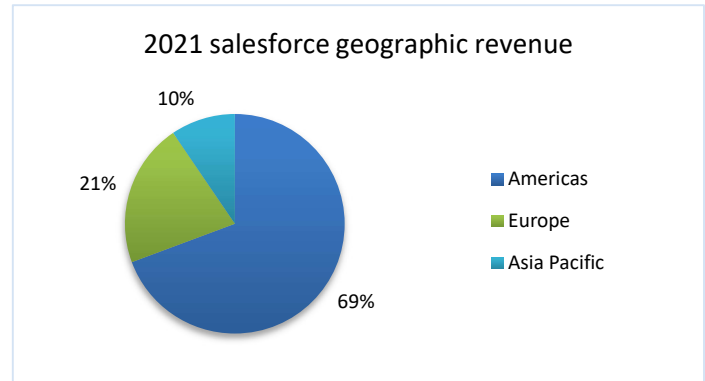
Having an integrated, cloud-based, and AI-powered platform, Salesforce.com, Inc. focuses on customer relationship management. It operates through the Sales, Service, Marketing & Commerce, Platform & Other, and Professional Services & Other five segments.<sup>1</sup> Salesforce generated about \$15.7 billion in revenue from the Enterprise Management Software industry, which weighs 73.84% of its total revenue.<sup>9</sup> As an industry leader, salesforce supplies to different sizes businesses in all industries all over the world.

## COMPANY DESCRIPTION

Founded in 1999, Salesforce quickly occupied the market share after launching the “software as a service” customer relationship management system. As a leading provider of the Enterprise Management Software industry, Salesforce focuses on offering customer relationship management software through the Customer 360 platform. The company derives revenues primarily from Subscription & Support and Professional Services. As shown in the chart below, Platform & Other, Service, Sales, Marketing & Commerce, and Professional Services & Other take 30%, 25%, 24%, 15%, and 6% in the fiscal year 2021, respectively. Salesforce merged Platform & Other, Service, Sales, and Marketing & Commerce as Subscription & Support in its 10K.<sup>1</sup>



Salesforce has expanded its footprint into different countries worldwide. As indicated in the geographic revenue chart, in 2021, about 69%, 21%, and 10% of its total revenues came from the Americas, Europe, and Asia Pacific, accordingly. The weight of Americas regional revenue increased at first and then decreased. There was a smoothly increasing trend in European regional revenue and a decreasing trend in Asia Pacific regional revenue.<sup>1</sup> Thus, we expect their weights to stabilize at 69%, 22%, and 9% in the next 10 years.

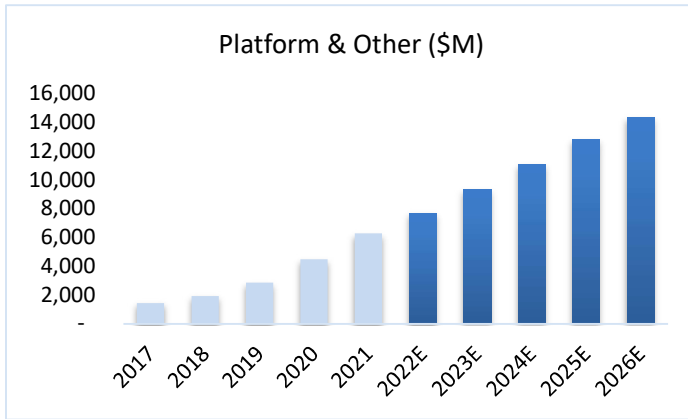


Source: 2020 Leidos Holdings, Inc. 10K

### Platform & Other

The Platform & Other segment helps companies to connect with and better understand their clients. In specific, this segment includes Platform, Analytics, and Integration three sub-segments. Trailhead is a free online learning platform that belongs to Platform. Platform enables clients to improve efficiency by customizing their own low-code business applications. Tableau is one of the analytics services that Salesforce offers. It aims to improve clients’ decision-making and allows clients to access from any devices. Integration services are powered by MuleSoft. It empowers clients the truly connected systems so that they can link data from different systems. These services are suitable for financial, healthcare, and scientific industry clients.<sup>1</sup>

As the largest segment, Platform & Other showed a strong performance in the last 5 years. It has a 34.2% 5-year CAGR which brought it from the third-largest segment to the first one. About 27.9% of the segment revenue was contributed from the acquisition of Tableau (August 2019). The pandemic made companies realize the importance of business digitalization. In other words, the need will continue to grow in the foreseeable future. Thus, we expect it to have a 13.27% 5-year CAGR through 2026 and contribute about 40% to the total revenues.

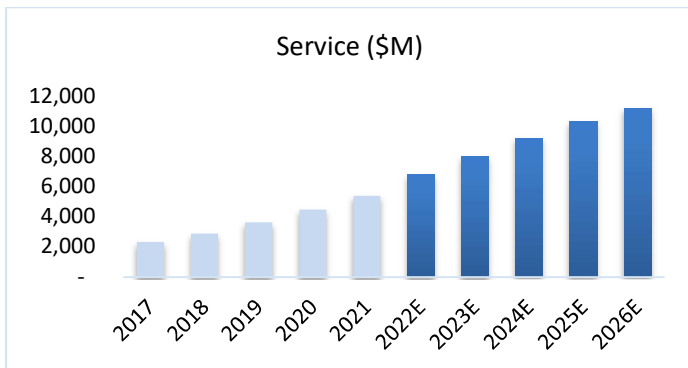


Source: Henry Fund Model<sup>2</sup>

## Service

In 2021, the Service segment earned the second position with a \$5377 million revenue. It enables companies to serve and support clients through different methods, which range from phone calls to digital channels to self-service options. Companies can connect different levels of employees together through the platform so that they can dispatch, track, and manage tasks online.<sup>1</sup>

We observed a relatively stable performance of Service. The proportion it contributed to the total revenues seems to fluctuate around 26%. The 5-year CAGR is 18.3% as of the fiscal year 2021. We expect it to maintain the 26.52% 10-year average weight level in the next 10 years.

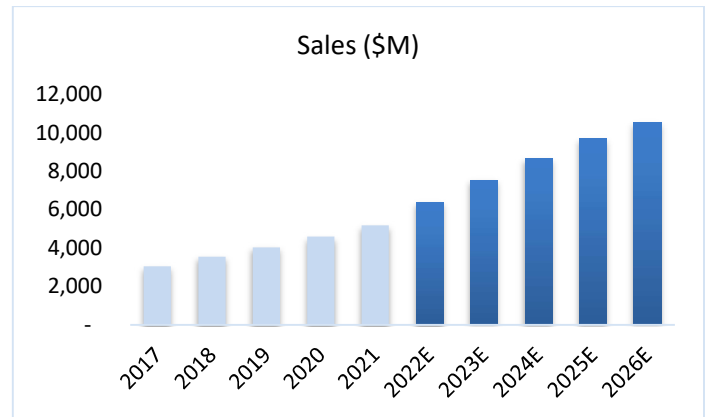


Source: Henry Fund Model<sup>2</sup>

## Sales

Targeting at helping consumers implement efficient sales processes, the Sales segment provides consumers solutions to store data, monitor sales, and project potential changes.<sup>1</sup>

Sales Segment used to be the largest segment which contributed more than 40% to the total revenues. But we observed there was a decreasing trend in recent years and it only weighed about 24% of the total revenues last year. It also has the lowest 5-year CAGR, which is 11.14%. However, we also observed that the decreasing rate is slowing down. Based on these, we project it could stabilize at 25% through 2031.

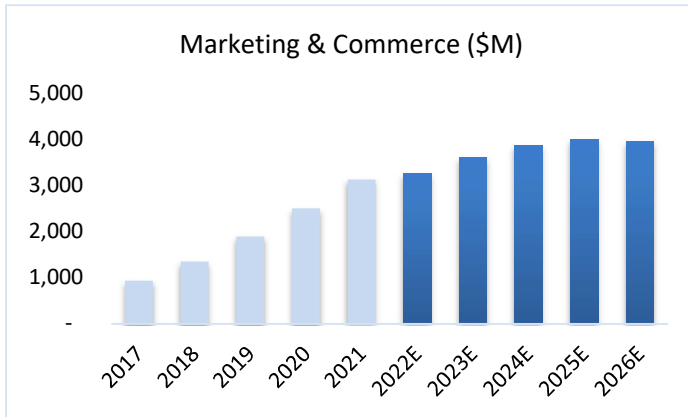


Source: Henry Fund Model<sup>2</sup>

## Marketing & Commerce

Marketing & Commerce is Salesforce's fourth-largest segment with Marketing, Commerce, and Experience three sub-segments. Marketing interacts with Sales and Service segments. It enables businesses to customize and personalize the marketing journeys through email, social media, mobile products, etc.. Commerce helps companies to build an outstanding ecosystem in order to increase consumer engagement and loyalty. Experience allows companies to directly connect and collaborate with people.<sup>1</sup>

Marketing & Commerce has a 27.41% CAGR over the last 5 years. Different from the Platform & Other segment, there was a slowing down trend in the growth rate. Therefore, we expect its contribution to the total revenue will gradually decrease and stabilize around 5%.



Source: Henry Fund Model<sup>2</sup>

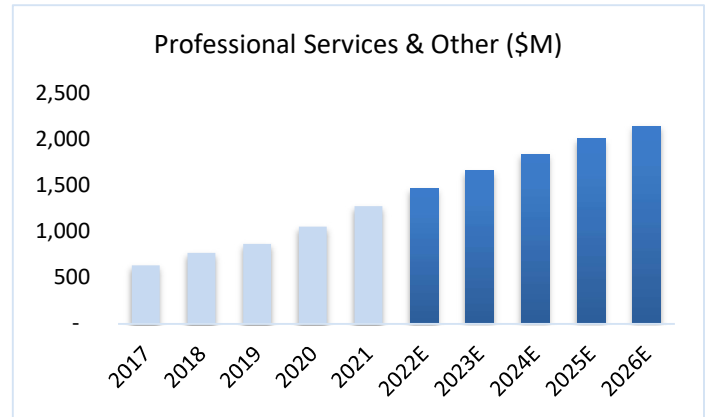
## Subscription & Support

Overall, the Subscription & Support revenue accounted for 96% of the 2021 Salesforce's total revenues. Historically, the revenue was primarily generated from subscription fees. But the recent acquisition of MuleSoft and Tableau broadened the revenue sources. Now it also includes the revenue from software license sales. The revenue increase was primarily brought by new consumers, upgrade, subscription renewal, and acquisition activities.<sup>1</sup>

The subscription period is usually between 12 to 36 months. It is hard to predict whether they will renew the subscription or not.<sup>1</sup> But based on the healthy and long-term relationship with different sizes of businesses, we estimate Subscription & Support have a 21% growth rate in 2022 and stabilize at 6% in the CV year (2031). The contribution to the total revenues will finalize around 95%.

## Professional Services & Other

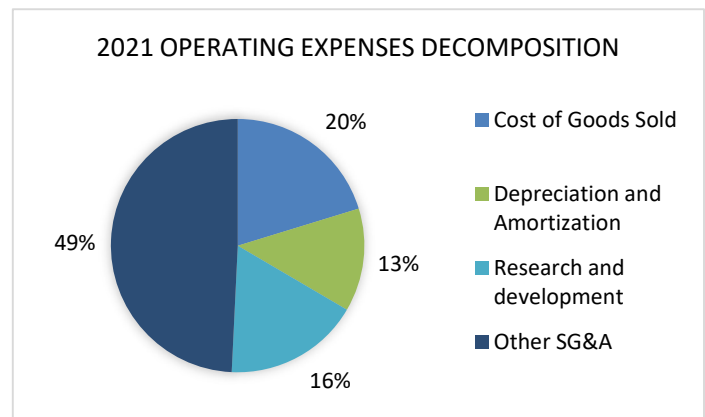
In 2021, Professional Services & Other generated \$1276 million revenue, which weighed 6% of the total revenues. It has a 14.95% 5-year CAGR. The revenue is driven by the higher demand from the increasing number of consumers.<sup>1</sup> We expect it to grow at 15% in 2022 and gradually slow down until reaches the stable 5% long-term growth rate. The contribution to the total revenues will finalize around 5%.



Source: Henry Fund Model<sup>2</sup>

## Cost Structure Analysis

As shown below, Salesforce has four major operating expenses: Cost of Goods Sold (20%), Depreciation and Amortization (13%), Research and Development (16%), and Other Selling, General & Administrative expenses (49%).



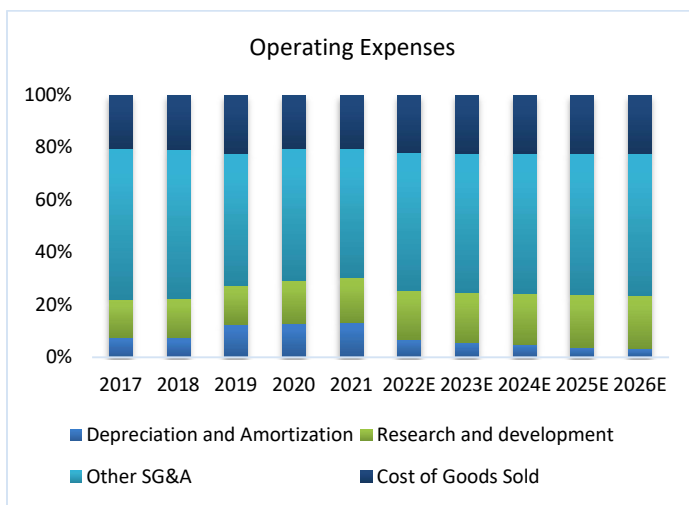
Source: Henry Fund Model<sup>2</sup>

## Cost of Goods Sold

As we mentioned earlier, the revenue mainly comes from Subscription & Support and Professional Services & Other. The Cost of Goods Sold also comes from these two sectors. As for last year, Subscription & Support and Professional Services & Other accounted for 76% and 24% of the cost of goods sold. The increase in COGS last year was driven by the increase of \$330 million employee-related costs, \$37 million in stock-based expenses, \$275 million in service delivery costs which were led by the efforts of increasing database capacity, \$222 million amortization costs, and an increase in the third-party related expenses.

According to Salesforce, the increase in service delivery costs was due to the fact that the delivery costs of software licenses are lower than the costs of cloud service offerings. This shift in business mix benefited the gross margin of Subscription & Support. The headcount related to data centers, support, and professional services has increased 18% since 2020. In order to better serve clients, Salesforce expects to invest more to improve data center capacity and cloud-based computing service ability.<sup>1</sup>

As shown below, we observed that the Cost of Goods Sold was fluctuating around 20% in recent years. In our assumption, there will not be any significant changes in this expense. We estimate it to be 20% of the total revenues in the projection period.



Source: Henry Fund Model<sup>2</sup>

### Depreciation and Amortization

As for the depreciation expense, we estimate it based on the calculation of the depreciation rate. The depreciation rate seems to vary around 22% in the last 5 years, that's why we decided to use the 10-year average depreciation rate of 22.1% to estimate future depreciation expense.

As for the amortization expense, we complied with Salesforce's amortization expense schedule. According to the 10K, the amortization expense will be \$1078 million in 2022 which is about half of 2021's number.

### Research and Development

In 2021, the \$832 million increase in R&D expenses was caused by the increase of \$508 million in employee-related costs, \$193 million in stock-based expenses, and the

expenditure on developing and testing data centers. Headcounts have increased by 11% since 2020.<sup>1</sup>

Salesforce expects the R&D costs will continue to improve and broaden the service offerings, develop new technologies, and integrate newly acquired companies.<sup>1</sup> Therefore, we assume 2022's R&D expenses will take 17% of the total revenues and stabilize at 19% in the stable phase.

### Other SG&A Expenses

Both marketing & sales expenses and general & administrative expenses are included in other SG&A expenses. The \$1878 million increase in other SG&A expenses last year.

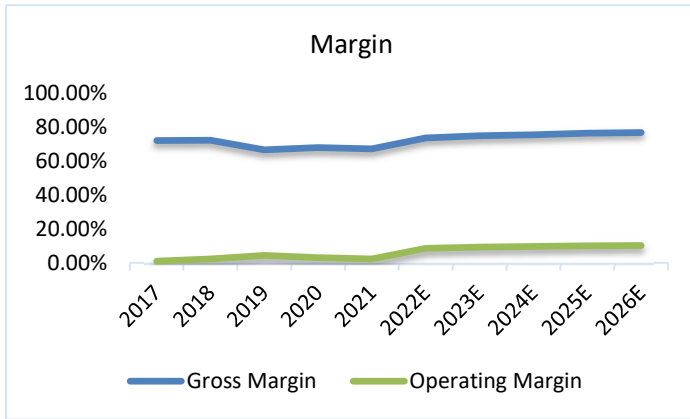
As for the marketing & sales expenses, the change was caused by the increase of \$1.4 billion in employee-related costs, \$89 million in stock-based expenses, and \$107 million in amortization expenses. Due to the pandemic, the decrease in travel and accommodation expenses partially offset the allocated overhead. The one-time partial minimum commission guarantee for the direct sales team also adversely affected the revenue. Since 2020, the headcounts increased by 14%.<sup>1</sup> With the economic recovery, we expect an ongoing increase in headcounts and travel expenses.

For the general & administrative expenses, the increase was led by the increase in employee-related costs and charitable donations to the ecosystem and community members. Since 2020, the headcounts have increased by 12%.<sup>1</sup>

Overall, we assume that in 2022, the other SG&A expenses will take 48.3% of the total revenues. There will be a slow but continuous increase until it reaches 49% in the stable growth period.

### Margin

The following chart shows the gross margin and operating margin from 2017 to 2026. In our projection, both of these two margins will increase in 2022. As we mentioned before, it's primarily led by the amortization expenses difference between 2021 and 2022. As most expenses will grow with the revenue growth, we expect the curve to be relatively flat through 2026.



Source: Henry Fund Model<sup>2</sup>

## Debt Maturity Analysis

According to the management, Salesforce will be able to satisfy the capital, debt repayment, and acquisition needs in the next 12 months. Salesforce's liquidity comes from the \$12 billion cash & cash equivalents and marketable securities. Besides, Salesforce entered a Credit Agreement with Citibank in December 2020, which allows Salesforce to borrow up to \$3 billion, which can also serve as a source of liquidity.<sup>1</sup>

Currently, Salesforce holds three long-term borrowings: \$996 million senior notes mature in 2023, \$1491 million senior note mature in 2028, and \$190 million loans mature in 2023. The total carrying value is \$2677 million. The future debt maturity schedule is shown below:

**Three-Year Debt Maturity Schedule**

| Fiscal Year Ending | Payment (in \$millions) |
|--------------------|-------------------------|
| 2022               | \$4                     |
| 2023               | 4                       |
| 2024               | 1,182                   |
| Thereafter         | 1,500                   |
| <b>Total</b>       | <b>\$2,690</b>          |

Source: 2021 salesforce.com, inc. 10K<sup>1</sup>

## ESG Analysis

According to Sustainalytics, Salesforce is ranked at the 7<sup>th</sup> position out of the 795 companies within the Software & Services industry, which represents a low exposure to different material ESG issues and a strong management of its relevant ESG issues.<sup>18</sup>

## Salesforce.com Inc

Industry Group: Software & Services

Country: United States

Identifier: NYS:CRM

### ESG Risk Rating

**11.2** Low Risk

0-10 10-20 20-30 30-40 40+

### Ranking

INDUSTRY GROUP  
Software & Services

7 out of 795

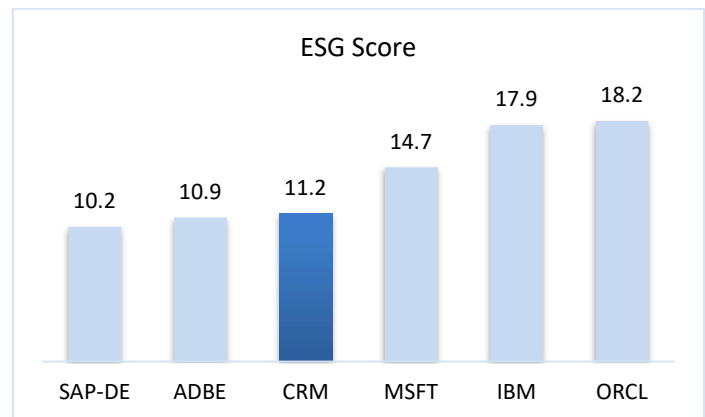
UNIVERSE  
Global Universe

211 out of 13843

Source: Sustainalytics<sup>18</sup>

As indicated below, all of these major players within this industry fall into the low-risk group based on the ESG scores. SAP-DE, ADBE, and CRM have relatively better ESG performance. FactSet notes that Salesforce has a medium controversy score and low risk.<sup>5</sup>

- Equality is one of the core values at Salesforce. Salesforce is committed to creating an equal workplace environment. Salaries and bonuses are reviewed annually to ensure employees are paid equally for equal work. As of January 31, 2021, Salesforce has spent over \$12 million on this.<sup>1</sup>
- Salesforce expects to have 50% of the U.S. employees made up of underrepresented groups by fiscal 2024. As of November 2, 2020, about 47% of the U.S. workforce was made up of these groups of people.<sup>1</sup>



Source: FactSet ESG<sup>5</sup> & Sustainalytics<sup>18</sup>

## RECENT DEVELOPMENTS

### 2021 Q4 Earnings Announcement

On February 25, Salesforce released the 2021 Q4 Earnings. The 19% year-over-year growth led to a \$5.82 billion fourth-quarter revenue, which beat the consensus by \$140 million. Specifically, Subscription & Support generated



\$5.48 billion and Professional Services & Other generated \$1.28 billion. The Q4 GAAP EPS was 0.28 which beat by \$0.22, and the operating margin was 3.3%.<sup>17</sup>

According to the 2022 guidance, Salesforce expects to have revenue between \$25.65 – 25.75 billion, an operating margin of 0.2%, and an EPS between \$3.39 – 3.41.<sup>3</sup> Our model has a slightly smaller 2022 Revenue of \$25.64 billion and EPS of \$3.26 as Salesforce includes the potential upside impact which will bring by the acquisition of Slack Technologies, Inc. We have a much higher estimation for operating margin, which we previously discussed.

## Mergers & Acquisitions Activities

As shown below, in February 2020, Salesforce acquired Evergage Inc., which focused on providing a cloud-based and real-time consumer data platform. The fair value was about \$100 million, which was made up of cash, stock options, and restricted stock awards assumed. The acquisition brought \$25 million developed technology and consumer relationships with useful lives for three to five years and \$74 million of goodwill. The financial results have been included in Salesforce's consolidated financial statements, but these results and transaction costs were not material.<sup>1</sup>

In June 2020, Salesforce acquired Vlocity, Inc., which was an industry-leading provider of cloud and mobile software. The fair value was about \$1.38 billion, which consisted of \$12 million cash, \$22 million accounts receivable, \$1024 million goodwill, \$473 million developed technology with 4 years useful life and customer relationships with 8 years useful life, \$15 million other assets, etc.<sup>1</sup>

In December 2020, Salesforce announced that it has entered a definitive agreement with Slack Technologies, Inc., which is a leading channel-based messaging platform provider. It is anticipated that the acquisition will close in 2022 Q2.<sup>1</sup>

In general, Salesforce tries to add new capabilities to the Customer 360 platform through acquisitions. As a result, we hold an aggressive attitude towards future M&A activities.

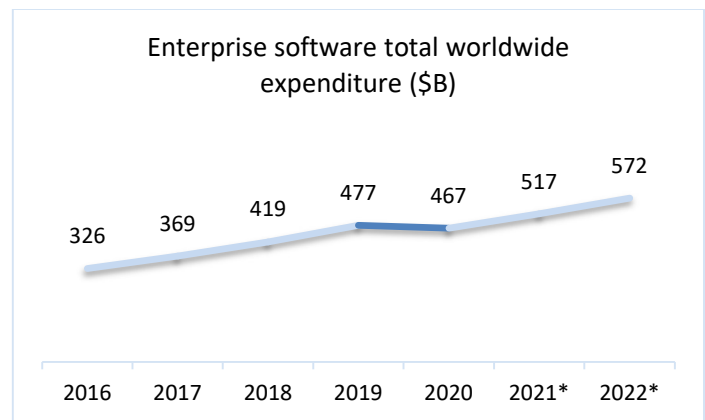
| Target Company           | Amount (\$M)                 |
|--------------------------|------------------------------|
| Evergage Inc.            | 100 (cash + stock options)   |
| Vlocity, Inc.            | 1380 (cash + stock options)  |
| Slack Technologies, Inc. | 27700 (cash + stock options) |

Source: 2021 salesforce.com, inc. 10K<sup>1</sup>

## COVID-19 Impact

Due to the COVID-19, the newly conducted businesses declined in 2021 Q1 as compared to the same period last year. As a response to the pandemic, the incremental operating expenses led to lower-than-expected operating cash flows. The pandemic affected clients' IT spending especially the enterprise software spending materially. As shown in the following chart, there was a \$10 billion decrease in the worldwide enterprise software expenditure. It will place a huge uncertainty on both renewal and new subscriptions, which will be reflected in future financial results.<sup>6</sup>

The downside effects were partially offset by the work from home policy, as well as the restricted business trips. Salesforce re-evaluated the office space needs, which caused approximately \$216 million of lease impairments. Moreover, the volatility in the foreign currency exchange market brought Salesforce some favorable impacts on remaining performance obligations. According to its 10K, the board will expect the fluctuations to continue in the near future.<sup>1</sup>



Source: Statista Enterprise software total worldwide expenditure 2009-2022<sup>6</sup>

## MARKETS AND COMPETITION

According to IBISWorld, Salesforce competes within the Business Analytics and Enterprise Software Publishing industry. Due to the complexity of enterprise technologies and the need for efficient systems, the industry revenue has grown by 13.5% per year since 2016. Although the pandemic shocked the global economy significantly, with the shift towards online operating, the industry revenue

still increased rapidly. With a relatively low barrier to enter the market, IBIS World expects the number of industry enterprises to grow at a 25.1% annual rate to more than 5,000 by the end of 2021. Due to this situation, many industry leaders are relying on acquiring companies that focus on cloud computing, analytics, and enterprise software to broaden their product lines.<sup>14</sup> We expect incremental demand and frequent acquisition activities continue to be the key drivers of the industry growth.

The industry is highly competitive and fragmented. Major players include Microsoft, Adobe, Oracle, Salesforce, SAP, and IBM (sorted by market capitalization). All of these companies concentrate most on the Americas market and concentrate least on Africa and Middle East market.<sup>7</sup>

## Peer Comparisons

| Company | Price (\$) | Market Cap (\$B) | Revenue (\$M) | # of Sectors |
|---------|------------|------------------|---------------|--------------|
| MSFT    | 232        | 1961.9           | 143,015       | 8            |
| ADBE    | 451        | 244.8            | 12,868        | 2            |
| ORCL    | 69         | 233.8            | 39,068        | 3            |
| CRM     | 205        | 221.3            | 21,252        | 5            |
| SAP-DE  | 102        | 157.5            | 27,897        | 3            |
| IBM     | 133        | 124.1            | 73,620        | 10           |

Source: FactSet<sup>7, 8</sup>

### Microsoft

Microsoft is a leading provider of software, services, and platforms. It mainly competes with Salesforce through cloud-based businesses. Specifically, the Productivity and Business Processes segment which provides services and solutions for productivity, communication, and information, and the Intelligent Cloud segment which primarily serves modern businesses and developers. These two parts account for 66% of its total revenue listed above.<sup>7</sup>

Compared to the other five companies, Microsoft does a good job at diversification as it operates in 8 different market sectors.<sup>8</sup> The geographic revenue decomposition is shown below. It earns 23% revenue from the Asia Pacific region which is the highest among these firms. Currently, Microsoft is trading at 43% above the 52-week low price.

### Adobe

Adobe engages in providing digital media and marketing services and solutions. It competes with Salesforce

through the Digital Experience segment, which offers products and services for optimizing consumer experiences. Adobe's business concentration falls in the Multimedia Design and Engineering Software industry instead of the Enterprise Management Software industry which only attributes to 21% of the total revenues.<sup>8</sup>

Adobe is not as diversified as Salesforce, it only conducts businesses in two sectors, which is the least among these companies. Adobe is trading at 45% higher than the 52-week low price.

### Oracle

Oracle does a good job at providing enterprise IT-related products and services. It competes with Salesforce through the Cloud & License and Services segments. The business concentration is the Diversified IT Infrastructure Software, which takes 83% of its total sales.<sup>8</sup>

Similar to Adobe, Oracle is not well-diversified as well. It operates in three sectors. Oracle is trading at 36% above the 52-week low price.

### SAP-DE

SAP SE provides cloud-based enterprise application software and related services for clients. It has four segments: Applications, Technology & Services, Services, Concur, and Qualtrics. The competition with Salesforce occurs in each of them. SAP SE earns 99% of its revenue from the Enterprise Management Software industry.<sup>8</sup>

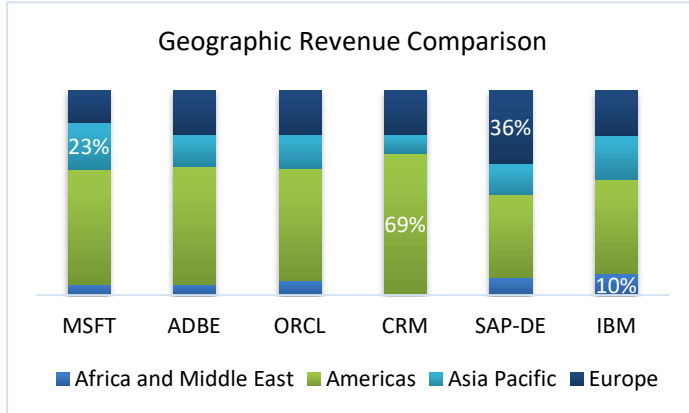
Even though SAP SE operates in three sectors, we believe it is the least diversified company as it almost only relies on the Enterprise Management Software one. SAP SE is trading at 13% above the 52-week low price and it places the highest weight (36%) on Europe market.

### IBM

IBM provides integrated IT services and solutions for clients to optimize their business processes. It is the most diversified company among these companies because it conducts business in 10 different sectors. The highlight is that only one sector weighs 27% of the entire business. None of the other sectors weigh more than 17% of the total. About 16% of the total sales are generated from the Enterprise Management Software. The competition with Salesforce is within the Cloud & Cognitive Software segment.<sup>8</sup>



As shown in the *Geographic Revenue Decomposition* chart, IBM has the highest percentage of revenue from Africa and Middle East market.



Source: FactSet GeoRev<sup>9</sup>

### Analysis

| Company | P/S  | P/E  | Gross Margin (%) | Operating Margin (%) |
|---------|------|------|------------------|----------------------|
| MSFT    | 12.7 | 38.1 | 67.8             | 30.9                 |
| ADBE    | 17.8 | 43.8 | 85.4             | 32.9                 |
| ORCL    | 5.7  | 18.0 | 75.6             | 36.4                 |
| CRM     | 10.2 | 52.7 | 67.3             | 2.1                  |
| SAP-DE  | 5.1  | 26.9 | 72.1             | 26.3                 |
| IBM     | 1.7  | 21.8 | 47.3             | 13.1                 |
| Average | 8.9  | 33.6 | 69.3             | 23.6                 |

Source: FactSet Comps<sup>7</sup>

The above chart shows the popular performance metrics we often use to evaluate companies operate within this industry.

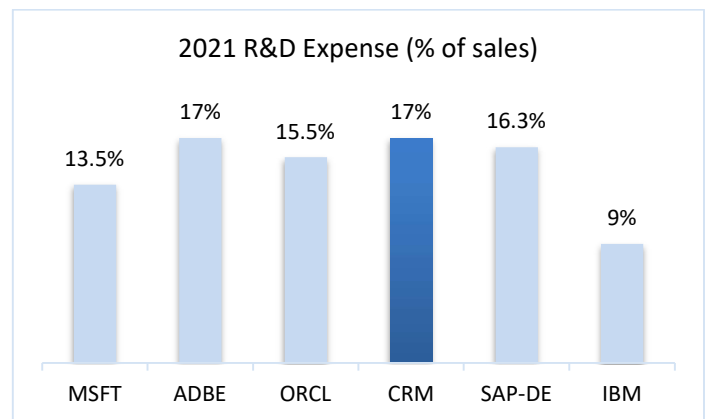
Adobe stands out when it comes to the P/S ratio and the gross margin. The P/S ratio is about twice as big as the average number. investors expect to pay \$17.8 for each dollar of its sales, which means that it is overvalued as compared to competitors. As we mentioned before, it mainly competes in the Multimedia Design and Engineering Software industry and it takes 79% of the total industry share. It is not surprising that it can generate an 85.4% gross margin. Salesforce has a higher-than-average P/S ratio and a slightly lower-than-average gross margin.

If we use the P/E ratio to evaluate companies, it seems that Salesforce is overvalued by investors with the highest ratio. But it also indicates that compared to competitors,

investors are very confident about Salesforce's future growth.

Shown below is the research & development expense as the percentage of sales for each firm. This kind of expense is critical for long-term growth. We expect Salesforce will continue to increase it in future years and make it stabilize at 19%.

As for the operating margin, it may be a concern that it has a significant lower-than-average number. This is due to the significant percentage of SG&A expenses (48.2% of total sales), which were dominated by marketing and sale expenses. The marketing and sale expenses consist of stock-based expenses, commissions for sales teams, payments to partners, marketing programs, and allocated overhead. We do not believe it will decrease in the future, but due to the decrease in amortization expenses, we expect Salesforce to have an 8.38% operating margin in 2022 and have a 5% margin in the long run.<sup>1</sup>

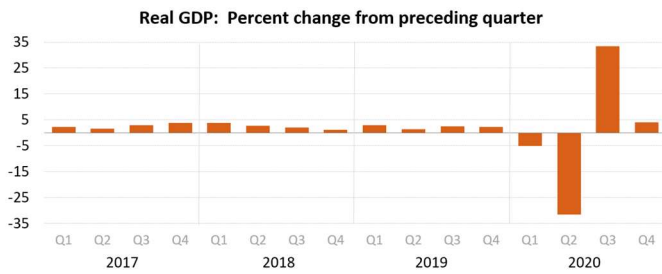


Source: FactSet 10K<sup>1</sup>

## ECONOMIC OUTLOOK

### Real Gross Domestic Product

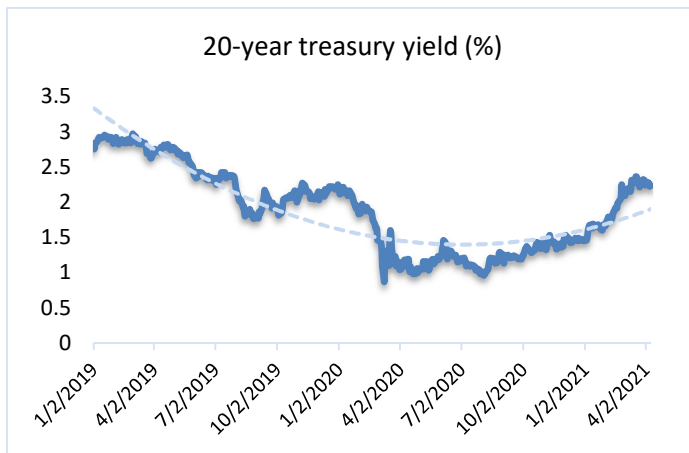
Real GDP is a non-biased inflation-adjusted measure of the value of economic outputs. As the following chart shows, it decreased 3.5% from 2019-2020. Although the growth rate in 2020 Q4 is substantial, it is the outcome of ongoing restrictions brought by the pandemic that offsets the continuing economic recovery. As the vaccination rates going up, the Henry Fund team expects to see a 5.17% growth in the next 6 months, and gradually return to the pre-pandemic level. With a relatively stable real GDP recovery rate, we believe there will be fewer uncertainties in major businesses.<sup>10</sup>



Source: Bureau of Economic Analysis<sup>10</sup>

## Treasury Yields

We chose to use the 20-year Treasury Yield as the risk-free rate. As we can see in the chart below, the market has experienced a low-interest-rate environment in the past 2 years. The lowest point was in March 2020, which was the outbreak of the pandemic. This environment did help companies who want to accomplish M&A activities. As we mentioned, the acquisitions of Evergage, Vlocity, and Slack were all during this period. However, both Henry Fund's assumption and the yield curve showed that the rebound tendency. We expect it to adversely affect Salesforce's future M&A activities and the cost of capital.<sup>11</sup>



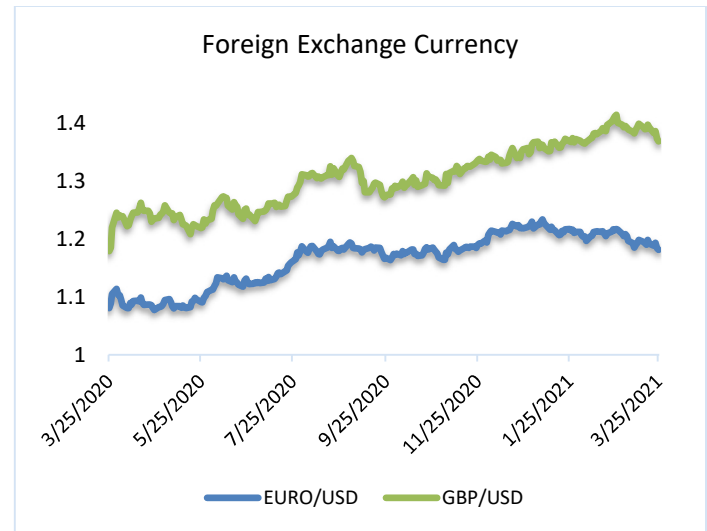
Source: U.S. Department of the Treasury<sup>11</sup>

## Foreign Currency Exchange

As we talked earlier, aside from the Americas market, Salesforce generates 21.2% and 9.5% of total sales from the Europe market and Asia Pacific market. The ongoing expansion of global scope exposes Salesforce to foreign currency exchange risks.<sup>9</sup>

Brexit and the new trade agreement between the U.K. and the European Union may adversely affect not only regional

but also global stability. We can see an increasing trend in EURO/USD and GBP/USD in the chart below. Due to the volatility, 2021 Europe revenues brought less favorable impacts than 2020. To avoid further uncertainties, Salesforce has began taken steps like the transition away from the U.K.. The transfer of specific intangible assets to Ireland brought Salesforce a \$2 billion net tax benefit in 2021. Based on it, we assume the company can maintain the same 26.76% marginal tax rate in the following years.<sup>1</sup>



Source: Yahoo! Finance<sup>12</sup>

## VALUATION

### Income Statement

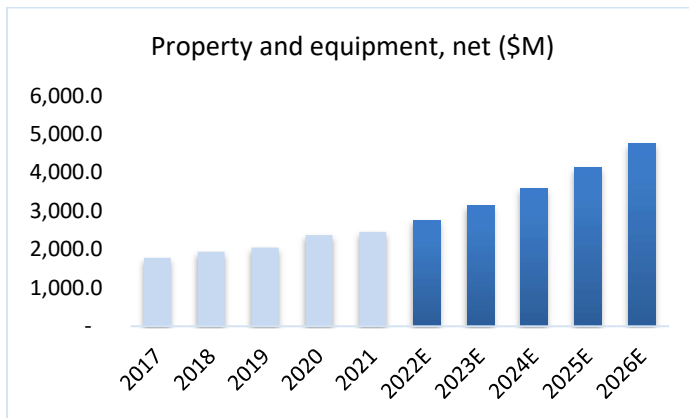
We estimate Subscription & Support have a 21% growth rate in 2022 and stabilize at 6% in the CV year (2031). We project Professional Services & Other segment revenue to grow at 15% in 2022 and gradually slow down until reaches the stable 5% long-term growth rate. Moreover, we estimate COGS, R&D, Other SG&A expenses to be 20%, 17%, and 48.3% of total sales, accordingly. (See *Company Description* for details).

In order to enhance the ecosystem, Salesforce invests in early-stage and mature-stage companies all over the world. In the fiscal year 2021, there was a significant increase in gain on strategic investment as two of the investments completed the IPO process. But due to the lack of reliable information, strategic investments require valuation and judgment. The future gain or loss is hard to predict. We chose to use the average return on investment to predict future status.<sup>1</sup>

## Balance Sheet

As the percentage of total sales, we observed an upward pattern in account receivable and a downward pattern in prepaid expenses & other current assets. We project the account receivable and prepaid expenses to weigh 39% and 4.5% in 2022. We assume they can reach the stable stage at 46% and 3% of the total revenues, accordingly.

We estimated the future net PP&E based on depreciation expense (depreciation rate times beginning net PP&E) and capital expenditures (assume maintain the historical average growth rate). As shown below, we believe net PP&E will increase gradually.



Source: Henry Fund Model<sup>2</sup>

Deferred revenue is the largest liability which weighed 59.3% of the total revenue. From 2012 to 2021, the proportion reached the peak (67.7%) in 2018. Then, there was a decreasing trend. We believe it will account for 59% of total sales in fiscal 2022 and stabilize at 58% in the future periods.

## Dividend policy

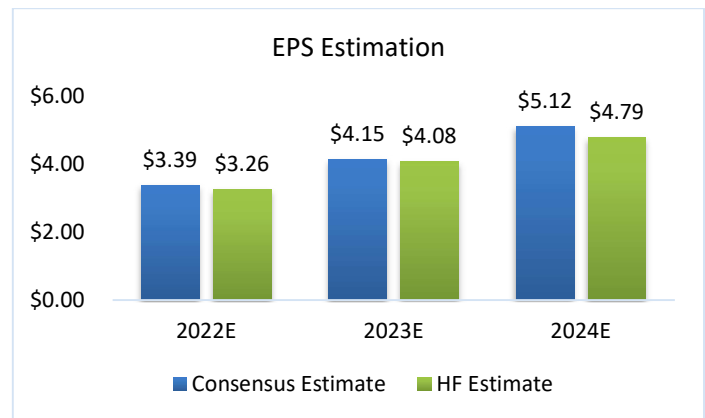
Historically, Salesforce has never paid any cash dividends. As the company is still at the growth stage, the board plans to retain earnings to support growth and developments in the future, which means that they will not pay cash dividends in the foreseeable future.<sup>1</sup>

## EPS

Salesforce had volatile earnings per share in recent years. With a \$4.48 EPS, it reached the peak in fiscal 2021 due to the higher-than-expected performance during the pandemic. As we mentioned before, it used merger and

acquisition activities, as well as strategic investments to accelerate growth and expansion. We believe there will be a 27.3% decrease in EPS next year and gradually increase thereafter.

As indicated below, the Henry Fund has a more conservative projected EPS in the next three years as comparing to the consensus. Salesforce had a 20.4% CAGR of total revenues in the most recent 5-year period and we believe it will continue to grow. However, we do not think it can retain such a high growth rate. Rather, we would like to see more moderate growth in the following years.



Source: Henry Fund Model<sup>2</sup>, FactSet Estimates<sup>13</sup>

## Models

As we introduced earlier, Salesforce did not pay any cash dividends and they do not plan to pay cash dividends in the future either. Therefore, we decided to use the DCF & EP model and relative valuation model.

### Discounted Cash Flow

The 7.48% cost of equity, 1.67% after-tax cost of debt, 97.12% equity weight, and 2.88% debt weight generated a 7.31% weighted average cost of capital for Salesforce. We have a 4.5% projected CV year NOPLAT growth rate and a 51.17% CV year ROIC. The discounted cash flow model yields a \$264.73 target price with these inputs, which shows a strong buy signal. It does not only consider the Income Statement data. It takes operating assets, non-operating assets, debt, operating leases, and employee stock ownership plan all into consideration, which provides us a much more completed and reliable long-term view. The economic profit model has the same implied share price as the DCF model.

## Relative Valuation

We selected the P/E ratio and P/S ratio to build the model. We calculated the average of these two ratios for Salesforce's peers (see *markets and competition*). We time the average P/E ratio with the projected EPS, which gives us a price of \$79.71. We also time the average P/S ratio with the projected sales per share, which yields a price of \$195.84. These ratios do not work well because Salesforce usually has much higher ratios than its peers, which means that the average level is unrepresentative.

## KEYS TO MONITOR

Overall, we project the target price range to be \$250 – 260, which implies a 22% - 27% upside from the current price as of March 25, 2021.

We should pay attention to the changes in its cost structures. As we talked earlier, due to the huge spending in SG&A expenses, it has a significantly low operating margin as compared to the competitors.

We believe there is a rebound in interest rates, which means that it is more costly to borrow than before. Under this situation, we should be more careful about holding M&A activities or issuing long-term debts. What is more, we should monitor the foreign currency exchange market as 31% of the total revenues are generated outside the United States. Last but not least, Salesforce got a \$2 billion net tax benefit by transferring intangible assets to Ireland, so track the potential tax benefits we earned from foreign countries is also necessary.

## REFERENCES

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