A N A L Y S T I N T E R V I E W

Identifying Horizontal Plays with Technology Moats in Application Software

BHAVAN SURI — WILLIAM BLAIR & COMPANY, L.L.C.

BHAVAN SURI, Partner, Co-Group Head of the technology, media and communications sector, joined William Blair & Company, L.L.C. in 2007 and specializes in the IT services and enterprise software industries. Previously, he worked in venture capital and early-stage technology commercialization. Before joining the financial services industry, he co-founded and managed a Boston-based enterprise software company. Before that, Mr. Suri was a Director at Answerthink, an IT services firm that specialized in systems integration and enterprise software implementation. Mr. Suri won an award in the *Financial Times*/StarMine "World's Top Analysts" listing as the number one stock picker in IT services in 2010. He received a B.S. in physics from Brown University and an MBA from the Kellogg School of Management at Northwestern University.

SECTOR — MULTIMEDIA SOFTWARE

(AGS801) TWST: Please start with a broad view of the macro environment business application software companies are operating in.

Mr. Suri: From a macro perspective, it's been interesting to watch what's been happening over the last 12 months or so. Application software vendors are operating in an environment where customers are looking to move costs from a capital expenditure basis to an operating basis. They are looking at SaaS or cloud companies to align their spend with operations as opposed to upfront capital expenditure. These companies are investing in things like security and analytics, and then trying to automate more of their tasks that are manual today. So you might see companies like **ServiceNow** (NYSE:NOW) and **Upland Software** (NASDAQ:UPLD) in that space.

And then there's a host of private companies that are playing into that sort of transformation automation. And certainly it's appealing to large businesses, which have automated a lot of their core supply chain tasks but haven't automated a lot of the services they deliver; but also very, very applicable to small businesses that have historically relied on Excel or Documents or Word or something like that, and are now looking to companies like **Zendesk** (NYSE:ZEN), which is a small-cap company, to automate many of their self-service tasks or customer service tasks and things like that. So it's an interesting environment because of constraints on capex, because of the focus on delivering value to the customer, sort of what we call front-end applications versus back office, where there's probably a little less investment going on.

Highlights

Bhavan Suri discusses the business application software sector. He says application vendors are seeing customers move costs from a capex basis to an operating basis. When evaluating companies, Mr. Suri looks at a company's TAM and for a moat around the technology. Companies discussed: ServiceNow (NYSE:NOW); Upland Software (NASDAQ:UPLD); Zendesk (NYSE:ZEN); RingCentral (NYSE:RNG); salesforce.com (NYSE:CRM); AppFolio (NASDAQ:APPF); AlarmCom Hldg (NASDAQ:ALRM); SAP SE (ADR) (NYSE:SAP); Tableau Software (NYSE:DATA); Qlik Technologies (NASDAQ:QLIK); Splunk (NASDAQ:SPLK); Sabre Corp (NASDAQ:SABR); International Business Machines Corp. (NYSE:IBM); Oracle Corporation (NYSE:ORCL); Microsoft Corporation (NASDAQ:MSFT); EMC Corporation (NYSE:EMC); PROS Holdings (NYSE:PRO); Amazon.com (NASDAQ:AMZN); Teradata Corporation (NYSE:TDC) and Datawatch Corporation (NASDAQ:DWCH).

TWST: It sounds like a significant theme for many applications is to serve a kind of environment where trimming is the goal?

Mr. Suri: It's a good question, but it is a mix. So a lot of them are where people are looking to trim, automation being the clear point there. For example, I can implement technology from **RingCentral** (NYSE:RNG), a small-cap communications company; it eliminates not just capex but also people, so resources that might be supporting on-premise systems. Even **Salesforce.com** (NYSE:CRM) — a very large-cap name — they continue to win because they provide a better-solution SaaS that allows you to eliminate a lot of their costs, not just from a capital expenditure standpoint but database administrators and report writers and things like that. And so that's certainly one of the drivers for some of these companies.

On the analytics front, however, those are expansion investments, because what we are seeing is a broader use of analytics by more people in any given organization. The goal is that you are seeing someone who may not have been looking at things analytically five, 10 years ago, now has some need for an analytical tool. They've typically been on Excel, which is OK, but doesn't really do a great job of sort of visualizing data, providing insight into data. So on the analytics front it's much more of an expansion budget.

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TWST: Looking across the space, do you see any subsector areas that have more attractive valuations?

Mr. Suri: That's a broad question. I think in every one of the sectors there are companies that are clearly overvalued, undervalued and fairly valued. When you look at the growth trajectories, we get into how we view robust companies. When you look at growth trajectories with large total available markets, we think there's a good set of companies that are undervalued. **Salesforce.com** is a good example. As I said, it's a large cap, and when 55% of your business at $6 billion to $7 billion is recurring revenue, it's growing north of or say close to 40%. So certainly it's very, very attractive at these levels.

Today when you look at smaller-cap companies like **RingCentral** or **AppFolio** (NASDAQ:APPF) or **Alarm.com** (NASDAQ:ALRM), we believe they look quite attractive given their growth rates relative to their valuation multiples. And then you look at some of the larger caps that are sort of legacy players such as **SAP** (NYSE:SAP), where you worry about growth rates slowing going into the future and margins compressing because of the shift potentially to a cloud model or acquisitions, they look a little overvalued because they are trading at a healthier multiple than the growth rate of their earnings implies. So there are companies across this range that we think fit a lot of those profiles.

TWST: Overall it's more of a case-by-case scenario?

Mr. Suri: I think we could be a little more specific; say in the data analytics case, you have a company like **Tableau** (NYSE:DATA), which is a great company growing 50%-plus, but it's trading at seven-ish times forward revenue. You have a company like **Qlik** (NASDAQ:QLIK), which is growing revenue in the mid-20% range, that is trading 4.5 times revenue. So it is on a case-by-case basis. Both of them trade at roughly the same free cash flow multiple for example, with one clearly growing faster and the other one growing slower. Obviously in a risk-aversive environment like this, you see people gravitating toward the one with the lower multiple.

TWST: What are the key points you consider and some of the metrics you use to evaluate a company in the space? What does a company need to make it onto your "buy" list?

Mr. Suri: It's actually fairly straightforward. I think there are two key things; one is a very large total available market. You want a large available market, especially for what we call horizontal plays — horizontal plays meaning that can be applied across industries. So when you look at analytics, we're looking for very large TAMs. **Tableau** and **Qlik** have TAMs that are in the $20 billion, $30 billion, $40 billion range in some cases, **Splunk** (NASDAQ:SPLK) similarly.

The second thing we tend to look for is some kind of moat around the technology, either patents or mass differentiation versus competitors and network effects. In some cases when you look at companies such as **Alarm.com**, their dealer network certainly differentiates them and provides a significant barrier to entry. When you look at **Sabre** (NASDAQ:SABR), the global distribution system and the network effects they have provide a significant barrier to entry. So it's some kind of moat or product differentiation we look for.

And the third theme is a management team that we trust and has executed consistently. Those are the base requirements that it takes to get on our "buy" list, and of course valuation relative to a sustainable growth rate.

TWST: Which are the technologies that most impress you? And which technologies stand out as delivering cost savings to a company's bottom line?

Mr. Suri: I think when you look at compelling technologies, we're excited about what **Splunk** is doing with their late-binding schema, and the scalability and connectivity of their engine. We also think the platforms that folks like **Salesforce** have built are critical in terms of a differentiating technology. For newer technologies, we look at the NoSQL databases and think companies like **DataStax** or **MarkLogic**, which are privately held, are executing very well and presenting threat to some of the very large incumbents such as **IBM** (NYSE:IBM) and **Oracle** (NYSE:ORCL). We also look at some of the guys like **Alteryx**, which is a private company, that are presenting threats to some of the larger incumbents in the space such as **Informatica**. So we do see those sorts of things playing out.

1-Year Daily Chart of Salesforce.com

Chart provided by www.BigCharts.com

And then on the question related to the bottom line, companies like **Zendesk** (NYSE:ZEN) — it's a small-cap name — are allowing for companies to deliver customer service in a cheaper, much more efficient manner that's helping the bottom line for those companies. They help with customer acquisition and customer retention, but they also allow you to automate processes. **RingCentral** is another small cap that is helping companies cut cost dramatically. **AppFolio**, a small cap, plays in the property management and legal verticals for small businesses, again helps cut costs by delivering technology and automating what they do manually in Excel and on paper. Certainly those are some examples of vendors that are delivering cost savings with newer technologies.

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TWST: Which three stocks from your coverage would you recommend as best bets for investors looking to get into the space now, and looking ahead into 2016?

Mr. Suri: Let's take the analytics space specifically. So I think as I look at companies right now, we pick **Splunk**, which is a midcap company. We think on the security side, they have very healthy proprietary technology there. And then on the IT operations management side and the DevOps side, side, we think their ability to ingest data and then provide incredibly fast analysis around system activity, whether it's to detect a security breach or to pinpoint the source of an application collapse, we certainly think that differentiates them. We do think they'll continue to grow in the 40%-plus range and continue to convert free cash flow at 20%-plus over the long term. And so that's a stock we like a lot that has pulled back quite a bit.

A smaller-cap name in that space that we like is **Qlik**, which is about a $3 billion market cap. We think they continue to execute well and could potentially accelerate revenue growth next year. Their Qlik Sense product, which is a visualization product, is doing quite well. Longer term, we think there's a good chance they get taken out. So we like those two companies.

Tableau is another company we like a lot. However, it's not one we recommend buying in the very, very near term. We have a "buy" on it, but there's some potential for volatility given the fact that they will likely provide initial 2016 guidance when they report on November 5 that may disappoint. So we wouldn't necessarily be pushing it ahead of that, but once they've given you the guidance, we feel quite comfortable there will be material upside to numbers for next year.

TWST: When you talk to top management of companies in the space, what are their chief concerns? And what are the headwinds they might be preparing for?

Mr. Suri: I think the biggest concern that all of these guys have is actually talent acquisition, to hire the right engineers and the right sales people, because you've got a lot of well-capitalized private companies that are aggressively poaching both engineering and sales talent. So I think that, especially when you are growing 30%, 40%, 50%, and you're a $700 million to $800 million business, hiring and retaining key talent becomes challenging.

Certainly all of them face some competition, so they do worry about that and monitor it, but we think the markets are big enough — certainly in **Splunk's** case, where most of the competitors are really ankle-biters, sub-$20 million, $30 million-type businesses. And then in the case of **Tableau** and **Qlik**, it's legacy guys trying to innovate or smaller guys again, ankle-biters. But really the biggest concern I think you hear is about talent acquisition and being able to acquire engineering experts.

TWST: What, if anything, could upset your rosy outlook for companies you like? What are the top risks that could emerge?

Mr. Suri: In terms of the vendors I cover that play in the self-service business intelligence market, **Microsoft** (NASDAQ:MSFT) has launched a product called Power BI, which has a price point that is quite low. Our view is that it doesn't have strong functionality or feature parity with the products from **Tableau** or **Qlik**. But if **Microsoft** continues to invest and offers a product at a very, very low price point, or effectively bundles Power BI with other products for free, it could extend sales cycles. So that's the one thing we do worry about outside of the talent thing that we talked about.

TWST: What's the level of M&A that you are seeing? And what do you expect to see going forward?

Mr. Suri: There's been some interesting M&A with the **EMC** (NYSE:EMC)/**Dell** merger recently. But there hasn't been a ton of M&A in the space; you've seen small tuck-in acquisitions, and certainly **Qlik** has made a few small tuck-in acquisitions. **Splunk** has made a few small tuck-in acquisitions. So, you do see that, but you don't see any big M&A.

1-Year Daily Chart of Qlik Technologies

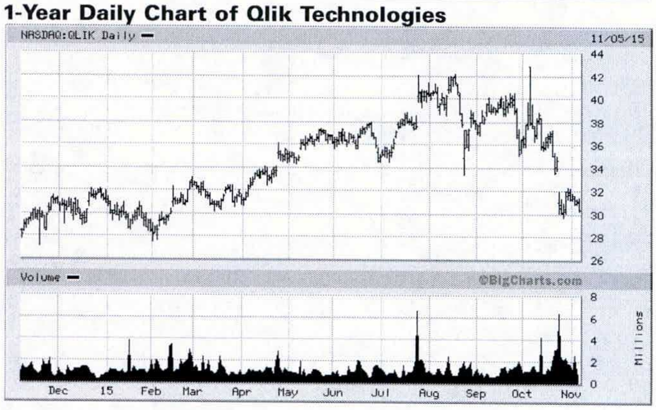

Chart provided by www.BigCharts.com

We're a little surprised. I think when we talked last time I said I thought **Qlik** could get bought. We still think that's true. We still think it's an attractive acquisition candidate. We think **PROS Holdings** (NYSE:PRO), which plays in advanced/predictive analytics space, will also be an interesting candidate. But you haven't seen a ton of analytics M&A. **Zendesk**, which is a small-cap, acquired a small, small analytics player a couple of days ago, but that was probably sub-$3 million in revenue.

So no material M&A in the space yet, but we expect it. You have seen private equity step in. **TIBCO** and **Informatica** were both acquired by private equity within the last 12 months. But nothing I would call strategic M&A is playing out yet.

TWST: Do you see any potential trends or themes that are below the horizon currently that could emerge more impactful going forward?

Mr. Suri: I think one of the things that people should focus on is what is happening at **Amazon Web Services** (NASDAQ:AMZN) and **Salesforce**, which involves people building cloud offerings to do analytics. And again, although we believe feature parity is well behind say **Qlik** and **Tableau**, do you want to bet against **Amazon** or **Salesforce** in that space? Some of these cloud-based players are doing quite well. And so that's one thing where you have seen analytics move from on-premise to the cloud, which investors should keep an eye on.

And the second trend is sort of this idea that some vendors might start to chip away at transactional database vendors like **Oracle** and **IBM**, which have traditionally owned the market. So you see companies like **MarkLogic** and **DataStax** starting to compete nicely against these vendors by offering multimodal NoSQL database architectures that are more performant for many types of workloads. We think that's another trend that people should certainly be aware of.

TWST: Any companies that have disappointed, falling short of your expectations where you've had to downgrade them?

Mr. Suri: Teradata (NYSE:TDC) and **Datawatch** (NASDAQ:DWCH) are examples of companies that we think have fallen short. I think in **Teradata's** case it was really a market penetration story and also the fact that the workloads of its customers are starting to change, which has kept them from being able to capture some of the very large capex spend they have seen historically. With **Datawatch**, I don't think they've had the ability to invest or really compete from a visualization perspective with some of the newer players like **Tableau** and **Qlik**. So those two have been disappointing.

TWST: Anything else you'd like to comment on before we conclude?

Mr. Suri: That's it.

TWST: Thank you. (VSB)

Note: Opinions and recommendations are as of 10/16/15.

BHAVAN SURI
Partner & Co-Group Head
William Blair & Company, L.L.C.
222 W. Adams St.
Chicago, IL 60606
(312) 236-1600
(800) 621-0687 — TOLL FREE
www.williamblair.com
e-mail: info@williamblair.com