ANALYST INTERVIEW

Growth Trends in the Software-as-a-Service Space

GREGORY DUNHAM — CREDIT SUISSE GROUP

GREGORY DUNHAM is a Vice President in the equity research group of Credit Suisse Group, where he covers small-cap software companies. Previously, Mr. Dunham covered application software for Deutsche Bank. At Deutsche Bank he was instrumental in building the firm's software-as-a-service coverage and was part of the team that was selected "Best on the Street" by *The Wall Street Journal* in 2007. Before working as an Analyst, Mr. Dunham worked in the software industry implementing packaged applications in the late 1990s. Mr. Dunham received his MBA from New York University and a B.S. in mechanical engineering from the University of Wisconsin, Madison.

SECTOR — INTERNET

(ABT811) TWST: Please begin with a brief overview of your coverage areas, including some of the specific names you follow.

Mr. Dunham: My focus is on the small-cap software space, really the small- to mid-cap software space. I tend to pick names with what I feel are the best growth opportunities. So in that context, I picked the software-as-a-service group as the initial roll out. Names in that space include **Ariba** (ARBA), **Concur Technologies** (CNQR), **Constant Contact** (CTCT), **IntraLinks** (IL), **NetSuite** (N), **Rackspace** (RAX), **RightNow Technologies** (RNOW), **SuccessFactors** (SFSF) and **Taleo** (TLEO). So that's my coverage universe as it stands.

TWST: The economy is still recovering at a slow pace. What trends drive growth in the software-as-a-service space?

Mr. Dunham: Much of it is that there is a secular shift within the software industry towards software-as-a-service generally. So it's not necessarily as much fueled by macro, although that does impact how these companies grow. But there is just a general shift that is driving growth for many of these interesting companies out there as they are providing a solution that's cheap, it's easy to deploy, you get much higher ROI on some of these offerings because it doesn't require upfront capital investments. And that's driving a lot of the growth for these smaller software-as-a-service players.

Highlights

Gregory Dunham discusses trends in the software-as-a-service space, including key growth drivers, opportunities in different customer verticals and new product development. He also shares specific insights on his top-rated stock picks and discusses possible IPOs and M&A activity within the space.

Companies include: Ariba (ARBA); Concur Technologies (CNQR); Constant Contact (CTCT); IntraLinks Holdings (IL); NetSuite (N); Rackspace Hosting (RAX); RightNow Technologies (RNOW); SuccessFactors (SFSF); Taleo Corp. (TLEO); Salesforce.com (CRM); General Electric Co. (GE); Oracle Corp. (ORCL); SAP AG (SAP); eBay (EBAY) and Siemens AG (SI).

TWST: Which customer verticals represent the best opportunities for software-as-a-service companies? Among the companies you cover, which are best positioned to take advantage of those opportunities?

Mr. Dunham: I think generally it was viewed originally as best suited for small- to mid-sized companies that are more likely to take advantage of software-as-a-service because they don't have the budgets to pay for the IT expenditures, hire the IT people internally and purchase all the infrastructure required to deploy software on premise. So initially companies like **Salesforce.com** (CRM) and others really pioneered the market more towards that SMB space; however, I think increasingly you've seen a lot of success within larger enterprises. And so if you look at the landscape today, I actually think near term that the buying appetite is actually better in larger enterprises right now, just because they are not as capital constrained. And so I think the names that are more exposed to that sized segment are going to actually perform better than the ones that are more concentrated to the SMB. The SMB environment is still tough for any purchasing due to the macroeconomy. Having said that, over time I believe that SMB is going to be a bigger driver to a lot of SaaS names than necessarily the enterprises because of the basic value proposition of SaaS.

By vertical, I think it depends really on the offering. Every company is different, and so one thing that I would say is that yes, this is a trend throughout software, and yes, most of these companies are growing at healthy rates and have very similar business models; however, each one of these companies has very different dynamics that are driving their businesses. So I think one risk to SaaS stocks and the overall trend of cloud computing is that every vendor is trying to attach themselves to that trend, and the business drivers are often very different, so you could have missteps from vendors who are not necessarily SaaS or cloud computing companies. If one vendor has a misstep in execution, that doesn't necessarily mean the whole segment should follow the same path.

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1-Year Daily Chart of SuccessFactors

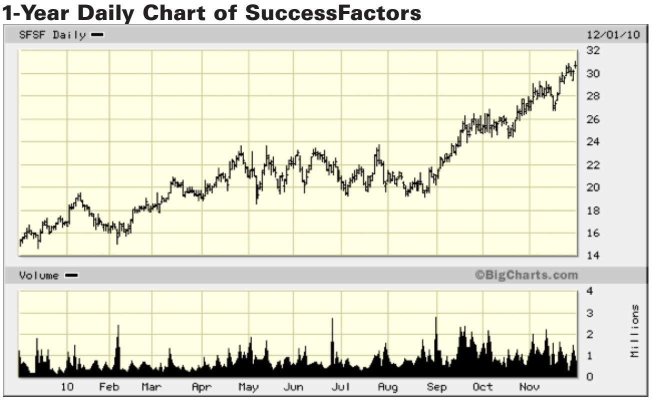

Chart provided by www.BigCharts.com

TWST: In this space, being on the leading edge of technology is important to maintain a competitive advantage. What particularly exciting new products or services might we see in 2011 from the companies you follow?

Mr. Dunham: For each one of these companies it's different. I think there are some interesting product cycles for some specific companies. **SuccessFactors**, for instance, this is a company that started mainly in performance reviews and goal management, but they are evolving their product suite to become a full human resources information system and their Employee Central product is an interesting product to watch in 2011. Employee Central is moving along a functionality path to do what **PeopleSoft** did back in client server, so that will be one that will be interesting to watch. I think **Ariba** is another company that has evolved from over the years. It was a B2B high flyer. It once held a market valuation of north of $40 billion — at that time I believe it was bigger than **GE** (GE), but you will have to verify that — but obviously the B2B bubble crashed. The company has evolved since those days and has moved into SaaS, and this has been quite successful. They've got a new offering that should go into GA later this year called Network Discovery, which matches buyers and suppliers in an automated format to try to do what **eBay** (EBAY) does for the consumer world in a B2B context. That will be one that will be interesting to watch. I think each company has different product cycle stories to them. I think the general view overall if you look across these companies is that while their products may have solved kind of an easy pain point and addressed white space initially, I believe that their products themselves are going to evolve to be much bigger than people expect. I believe that SaaS vendors are likely to be effective at doing that because the pace of innovation for some these SaaS companies can be very high.

TWST: Are there any industry-specific metrics investors should evaluate before getting into the sector?

Mr. Dunham: I think it's important to do your work on each specific name. I would be cautious to put a kind of cloud monitor on the general group as these companies are so different from one another. The most important thing with a software-as-a-service company's fundamentals, in my view, is the renewal rates that they have with their customers. The success rate of their customers is really the driver to renewal rates. The gross margins that they get on their customers is a sign of leverage going forward and their competitive positioning and growth opportunity, supported by the total addressable market. But for all of these stocks, it all comes back to fundamentals. As a new investor, what I'd watch out for is not to be fooled by labels of cloud computing or software-as-a-service, because each company is very different and has their own unique drivers.

TWST: You have some "neutral" ratings and some "outperform" ratings on your stocks. Valuations are at historic highs and the stocks are also pretty volatile. Why is this a good time to invest in the space?

Mr. Dunham: I believe it's still a good time in general for long-term investors because while valuations are high, total SaaS market cap is still about $30 billion in total. I think putting that in perspective, that's a fifth the size of what **Oracle** (ORCL) is. So we're still very early days. I also believe there is DCF analysis supporting current valuations for many companies. I believe that with growth these SaaS companies will show much more leverage than investors perceive because contribution margins on the renewal streams are very high.

As the mix of renewals increases, these companies will generate significant cash flows. Now having said that, yes, relative valuations have moved to historic highs in the past few months. I think some of that is really due to two things. One, I think it's just a market phenomenon where you have very low interest rates, which increases the value of long duration growth stocks, number one. So fundamentally you have lower discount rates, which make these growth stocks more valuable. So that is just a fundamental reason why. And I think the number two, the second thing that has helped some of the software-as-a-service stocks, is that they have exhibited good leverage on a free cash flow line through the recession. And I think that has increased investor confidence and the leverage, and the sustainability of that leverage going forward. They went from basically making 0% free cash flow margins in 2008 to on average posting close to 10%, so I think that is something that I think has garnered these companies to get a little bit more of a valuation multiple than historically. But that said, I don't believe you have the same level of near-term upside as you did in August when I launched on these names.

TWST: Are there any IPOs or M&A activity on the horizon that investors should keep an eye out for?

"I think there will be IPOs for sure. There are a lot of private software-as-a-service companies. I think the timing of that could vary, but there are many different interesting smaller software-as-a-service companies that will become public over the next few years, and some of the private companies may be acquired potentially by companies that are already public."

Mr. Dunham: I think there will be IPOs for sure. There are a lot of private software-as-a-service companies. I think the timing of that could vary, but there are many different interesting smaller software-as-a-service companies that will become public over the next few years, and some of the private companies may be acquired potentially by companies that are already public. **Concur Technologies**, **Taleo**, **SuccessFactors** — all three of these companies have raised significant amounts of cash to do M&A internally within the SaaS space. I do believe that you also may see companies like **Oracle** and **SAP** (SAP), and other bigger software companies buy into software-as-a-service companies via acquisition. Having said that, I don't believe it's going to be as near term as perhaps other investors believe, and that's where I may differ than some others on the Street.

1-Year Daily Chart of Constant Contact

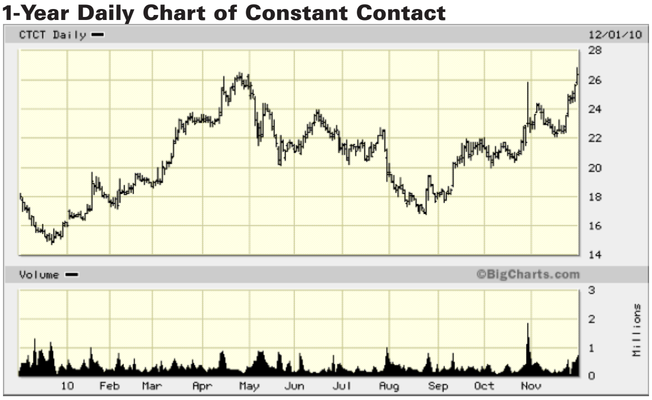

Chart provided by www.BigCharts.com

TWST: If you had the opportunity to advise the management teams of the companies you cover to do something differently or to provide the investment community with some additional information or insight, what would you tell them?

Mr. Dunham: I would love more detailed and transparent measure of churn across the overall space, because that is what really drives the value of these companies. Different companies measure things differently, and that variable is not easy to compare and contrast within and across every company. From a strategic standpoint, I don't have a general kind of view. My view is that I would encourage these companies to invest aggressively — if the addressable market and appetite for your solution is there — only if you have very sticky solutions, where churn is low and your contribution margins on your renewals are high. But it really depends on each company. They vary dramatically. Fundamentally, I'm not opposed to people running their business at break-even profits if they can generate cash and they are confident that they are adding customers that will be very profitable down the road.

TWST: For the names you have "neutral" ratings on, what are the things that you will be looking for to upgrade them?

Mr. Dunham: So **Concur**, **CNQR**, they report tonight. It's a great company. It generates a ton of cash; it's got a good revenue growth profile. The valuation is priced as a premium, but I don't think it's overly expensive by any means. I think what would get me more excited about **Concur** would be a return to that low to mid-20s organic growth, and sustainable growth at that. I believe they can if they are successful with some of their international strategies. I just would like more evidence of that, because we're still in the pretty early days in their international expansion.

Constant Contact would be the next "neutral"-rated stock. This is a company that has done a fantastic business thus far. I'm projecting they grow revenues by 35% this year. One of the challenges associated with **Constant Contact**, however, is that they sell to the SMB environment and the very, very low-end of the SMB. Something like 70%-plus of their customers are companies with less than 10 employees, and because of that, in conjunction with the recession, that has dampened their ability to add new customers. And so if you look at some of their leading metrics on the business, they are showing signs of growth slowing at a fairly dramatic clip, and that's mainly due to the recession. The company, the management is a very good management team, and what they are doing to adjust is they are trying to cross sell more products. I don't think we've seen the evidence of cross-sell be successful yet to a significant level to where you don't have meaningful compression in growth. I think what I would need to see to get more optimistic on **Constant Contact** is evidence of much stronger cross-sell in the business or a much better SMB macro environment.

RightNow Technologies is another "neutral." This is a stock that has done very well recently. The company put up a pretty strong 3Q, where bookings really outpaced where its expectations were. They have a very happy customer base and get good renewal rates on their business, and they are really the leader in Web self service for B2C companies. What would get me more excited is, I think, better demonstration of cash generation in the business. If you look at this company on a free-cash-flow basis, according to my estimates, it is actually priced at a premium to the overall group. Part of that is due to the fact that their free cash margins are lower. I would like to see that be higher for me to get more optimistic as they leverage the model. Also, any more data points that show an acceleration to growth beyond 20%-plus organic would give me more confidence.

TWST: Why did you rate Taleo as "neutral?"

Mr. Dunham: Taleo — I did just downgrade the stock from "outperform" to "neutral" following a very strong stock performance. The bottom line is that I like the company; I think they've got a lot of things going for them, and I think they've got a big opportunity in the talent management space. Their stock has worked since my launch. I think since I launched, the stock has gone from the mid-$20s, and now it's $31. But a lot of these stocks have worked. The reason why I'm taking my foot off the gas on **Taleo** is more due to the fact that their 3Q didn't show as much growth as I was hoping for. Their applications billings specifically were up 2% year over year. Most of these other companies are growing on average 20%-plus, some a little lower than 20%, some as much as 40%. So given the fact that their growth was lower, understandably so, but the stock has had a big move. I'm waiting for more evidence for growth to return to that 20% level on an organic and a consistent basis.

TWST: What are your top-rated names and why?

Mr. Dunham: My top two ideas right now are **SuccessFactors** and **Ariba**. **SuccessFactors** is growing the fastest. They will post probably north of 30% billings growth on an organic basis this year. They generate $0.20 on the dollar in free cash flow. So they generate good cash flow, they are growing the fastest, and they are releasing — they are evolving the product portfolio to really address a very big market opportunity. They've got pretty much five products that are coming out that each on its own could be a billion-dollar market in Inform, or their workforce analytics product. They also bought a company called **CubeTree**, which is a social collaboration platform for the enterprise. In addition, they have a new recruiting module that they've built with the help of their relationship with **Siemens** (SI) that has the potential to be very big. And the final pieces of that product that I mentioned earlier, the Employee Central product, which has the potential to be a full-scale HRIS system, which has a very big market opportunity. So if you look across the business, they are growing faster in its core, but I believe they are laying the groundwork for sustained growth at very high levels, while also generating very good cash.

TWST: What do you like about Ariba?

Mr. Dunham: Ariba is a little different. The valuation is well below the peer group on a free-cash-flow basis for 2011, and part of that is due to the fact that they are more of a transition story. This is a company that has evolved into a software-as-a-service company, but they are doing things very well in their software-as-a-service business. And I believe that over time, as this SaaS business of theirs gets to be 60%, 70%, 80% of revenues, which is what you are going see over the next four or five years, that you'll see revenue growth rates accelerate, you'll see good margins, and I think people will become more aware of the defensibility and the growth opportunities that this company has.

TWST: Thank you. (MES)

Note: Opinions and recommendations are as of 11/10/10.

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