Playing the Cloud-Based Software, Big Data Analytics and Cybersecurity Themes of Application Software

SAMAD SAMANA — FBR CAPITAL MARKETS & CO.

SAMAD SAMANA is a Vice President in the technology, media and telecom research group of FBR Capital Markets & Co., specializing in enterprise software. Before joining FBR Capital Markets & Co. in April 2011, Mr. Samana worked as an Associate Analyst at Morgan Keegan & Company in Memphis, Tennessee, covering enterprise hardware and enterprise software companies. Mr. Samana's broad technology knowledge, comprehensive network of industry contacts, and six years of sellside research experience allow for a unique perspective into enterprise software companies. Mr. Samana received his B.A. in international studies from Rhodes College in Memphis, Tennessee. He is also a Level III CFA candidate.

SECTOR — MULTIMEDIA SOFTWARE

(AFT801) TWST: Can we start with some background on you and your coverage?

Mr. Samana: I have been working in equity research for my entire career. I started off at Morgan Keegan, working with an Analyst that covered security and infrastructure software companies, and then I moved over to FBR Capital Markets, my current firm, covering application software. Currently my coverage focuses primarily on the cloud software companies, so examples would be **Workday** (WDAY), **Salesforce.com** (CRM), **NetSuite** (N), **Ultimate Software** (ULTI) in that broader space. We have another Analyst at the firm who focuses on security and infrastructure; my primary focus is on the application side and more specifically on cloud software.

TWST: Can you give us a general view of the sector now, how it's doing, what the valuations are?

Mr. Samana: The space has had a challenging year in 2014. From a fundamental perspective, the companies in cloud-based software continue to see robust growth with growth rates ranging from 20%, all the way up to the high 50%, 60% depending on the specific company. So from a fundamental perspective, you haven't seen a dramatic shift.

Highlights

Samad Samana discusses his coverage of application software. While Mr. Samana says the space has had a challenging year in 2014, from a fundamental perspective he says cloud-based software service companies continue to see robust growth. Mr. Samana recommends investors focus on the key themes of cloud-based software, Big Data analytics and cybersecurity. He says the key area to focus on is companies that are moving to next-generation data centers and cloud computing. Mr. Samana also touches upon the concern around cloud security, as well as the rise of the omnichannel software and payments trends.

Companies discussed: Workday (WDAY); Salesforce.com (CRM); NetSuite (N); The Ultimate Software Group (ULTI); Adobe Systems (ADBE); Oracle Corporation (ORCL); SAP SE (SAP); MasterCard (MA); eBay (EBAY); Apple (AAPL); Samsung Electronics Co. Ltd. (005930.KS) and Google (GOOG).

You see robust demand, you see white-hot growth, you are starting to see some margin efficiencies for many of the companies and also cash-flow expansion, but the space has experienced a valuation contraction. That has been driven largely by investors trying to evaluate when these companies will start to become profitable and how quickly they can reach peak profitability. As more and more companies enter the cloud space, it both validates the opportunity and also introduces greater competition. So the question arises whether these companies can actually grow into the valuations that they are currently trading at.

TWST: Among the profitable cloud companies, which companies are doing best?

Mr. Samana: In the cloud space, you have many companies that have done very well, and a lot of that is driven by them achieving scale. **Ultimate Software** is a good example; they have operating margins in the high teens. **Salesforce.com**, which is the largest standalone cloud software company in the world, has made a commitment to delivering operating margin as well. So you are definitely seeing the theme of these companies starting to deliver more and more margin even as they deliver this very solid level of growth.

Another example of a company that has healthy margins and rebounded margins in the cloud is **Adobe** (ADBE). That was a company that went through a transition from a license model to a subscription model, and now that they are on the other side of that, they are seeing significant margin expansion as well. We think for many of these companies, as you look further down the road and how these stocks will perform, that's going to be a bigger theme in the future.

> ***"The key themes for investors to focus on remain the white-hot growth areas, such as cloud-based software, Big Data analytics and cybersecurity."***

TWST: Are there any macro trends that will help drive growth or cause difficulties for companies in the application software space?

Mr. Samana: We are still seeing an overall IT spending growth environment in the 2% to 3% range from an overall perspective, but we think the key themes for investors to focus on remain the white-hot growth areas, such as cloud-based software, Big Data analytics and cybersecurity. And really the key area to focus on is for companies that are moving to the next-generation data centers and cloud computing and those type of applications.

From a macro perspective, in what is still a constrained spending environment, companies increasingly want to move to the cloud to capture the efficiencies there. They want to roll out next-generation cloud-based applications that are designed for a much more social and mobile workforce with different interfaces that are much closer to consumer-like technology as well.

TWST: What are some companies that are best positioned to take advantage of these trends?

Mr. Samana: There are several companies well-positioned to benefit from the secular shift to the cloud. We would highlight **Salesforce.com**. They are the largest cloud software company in the world. They continue to be one of the most innovative and transformative vendors. They are diversifying their products; they have already done a commendable job going beyond salesforce automation into areas like service, digital marketing, and now with a Big Data analytics cloud offering on the horizon as well. They continue to position themselves to be the dominant cloud vendor at least for front office applications for years to come.

Another very strong contender in the space is **Workday**. They are the clear leader in cloud-based HR software today. They've done a very good job of penetrating large enterprise customers. Co-founders Dave Duffield and Aneel Bhusri, ex-PeopleSoft leadership, are finding with **Workday** the same customer base and loyalty that they experienced at PeopleSoft. And the company is benefiting these customers as they move over to **Workday** with these next-generation applications in this massive HR software replacement cycle.

TWST: I know you said that security is not your focus, but I wonder if security questions are a major concern for the cloud companies you follow, and which of them are best positioned to take advantage of having good solutions in that area?

Mr. Samana: Cloud security is very much in the forefront. Every day you hear about increasingly sophisticated cybersecurity threats, whether it would be on corporations or increasingly at the government level. What that's done is drive robust demand for advanced security solutions because IT departments have to build up their legacy firewall defenses. There is a broad basket of security software vendors that we think would be attractive candidates to look at as you continue to see more and more sophisticated cyberattacks out there.

As it relates to the application software space, cloud security is also a concern and gets brought up in the sales process for companies, especially as they try to sell their cloud solutions outside of the United States. For U.S.-based vendors, a concern that has arisen in the last 12 to 18 months has been data privacy and security concerns for international customers after the NSA leaks. So increasingly even cloud software vendors in the United States are expanding their data centers into Europe, into Asia to have their data centers physically located there to alleviate any data privacy and security concerns for international customers. That way they can meet local regulations and local laws.

TWST: Are regulations tougher in some other countries other than the U.S.? Is that a factor or is it just a perception that they prefer keeping it local?

Mr. Samana: It's difficult to say whether they are tougher, that can really be very much on a country-by-country basis. But if you look generally, there is some wariness for customers in Europe to want to use a U.S.-based vendor if they only have data centers in the United States. It's just a natural part of any successful cloud company's growth strategy to also have on their roadmap data centers outside of the United States. You are already seeing multiple companies go down this route, whether it's having their own physical data center or using a third-party data center located outside the U.S.

1-Year Daily Chart of Adobe Systems

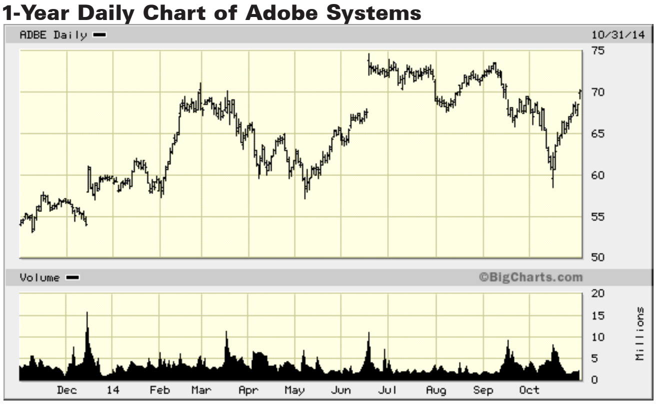

Chart provided by www.BigCharts.com

TWST: Are there any up-and-coming companies that you are watching, companies that perhaps are not public yet or just small companies that could disrupt some of the bigger and more established companies?

Mr. Samana: There are definitely many companies that continue to innovate in the application software space. Some key players that are out there that many investors are keeping an eye on are companies such as **Box** and **Square**. I think those are two great examples of companies that have been very innovative in their respective fields. And really, I think that's the key for any of these larger enterprise cloud vendors that have been the early trail blazers to continue to deliver the growth that they have, they have to maintain that innovation and maintain that culture that has separated them from these legacy software vendors such as an **Oracle** (ORCL) or an **SAP** (SAP).

TWST: Can you tell me a little more about Box and Square? What makes them innovative?

Mr. Samana: Box is one of the early pioneers in cloud-based storage, file sharing, content management and collaboration. It really changed the traditional way that enterprises and individuals share information both within the enterprise and then extending outside of the enterprise as well. One of the benefits for these companies that have grown up with a cloud mentality is that they were built for a more mobile world and designed to integrate more easily with other cloud-based technologies. We believe this has been a key differentiating factor for **Box**.

Square was more disruptive on the mobile side of the world in payment processing. The company started off as a provider of credit card readers for different mobile devices such as the iPhone and iPad, and more recently has expanded its offerings to include invoicing, analytics and other merchant services-related software. The mobile payment industry is one that we believe is in the very early days of its evolution and will be a greater focus for both enterprise and consumer software vendors.

TWST: What are some of your favorite stocks in your space right now and why?

Mr. Samana: Salesforce.com is one of our favorite ideas, and there are multiple reasons; one, the company itself continues to deliver strong growth for a company of its size. They have also made a commitment to delivering margin expansion, which we believe is an increasingly greater focus for investors even on the growth side. They continue to diversify their product line and over the last 12 months, they have made some significant changes, they really beefed up their sales force, their internal sales teams, and they have made some changes in leadership. We believe it's really positioned the company to continue to move toward their long-term target of $10 billion of revenue and be the dominant cloud software company.

TWST: Any other companies that are top of mind besides Salesforce?

Mr. Samana: Another company that we really like right now is **NetSuite**; they were a leading pioneer in cloud-based ERP solutions, particularly in financial management applications. If you think about the different areas in the cloud and the penetration in enterprises, ERP has been one of the slower areas to move to the cloud. But in recent years, there has been an accelerating level of adoption of cloud-based ERP, and we believe **NetSuite** is one of the companies best positioned to capture that trend.

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Additionally, in the recent past they have moved into cloud-based e-commerce software and omnichannel commerce software. That's another vertical that really has not seen very much innovation in the cloud, there are only a handful of players, and we believe **NetSuite** has positioned itself to benefit from that transition as this trend continues to pick up.

TWST: Can you give me an explanation of omnichannel software?

Mr. Samana: There are different points where a retailer deals with customers such as mobile, in-store, in a catalog, over the phone, etc. An omnichannel commerce approach creates a similar customer experience across these different sales channels, and in order to do this, companies are having to move to next-generation omnichannel commerce software platforms. A robust omnichannel platform provides applications for e-commerce, point-of-sale, order management, merchandising, inventory and other areas along the supply chain to improve a company's retail operations.

TWST: And that's a trend that is now picking up?

Mr. Samana: Exactly. That's an area where retailers have been very, very cutting-edge in using Big Data analytics and using data to improve retail sales. The one area that they haven't really embraced as closely is moving their e-commerce or their different commerce software applications into the cloud to protect the data because of the proprietary nature of customer data. But with the cloud validated as a strong alternative to traditional on-premise deployments, even retailers are increasingly embracing cloud-based e-commerce solutions.

1-Year Daily Chart of Salesforce.com

Chart provided by www.BigCharts.com

TWST: What about mobile payments? That's been on the radar for a while, are we beginning to see a pickup in demand for that?

Mr. Samana: We believe the focus on mobile payments will continue to pick up. We live in an increasingly mobile world, and this has given rise to new disruptors such as **Square** that are transforming the payment industry. Even traditional financial services and transaction processing companies such as **MasterCard** (MA) are rolling out mobile payment solutions. More recently **eBay** (EBAY) has revealed it will spin out **PayPal**.

Probably one of the biggest announcements for the mobile payment industry recently was **Apple** (AAPL) revealing Apple Pay. The company has really transformed the way people will view mobile payments, partnering with several banks, retailers and app providers. As you look out over the next 12 to 24 months, that will continue to be a trend in the technology space.

TWST: For an investor that wants to play that trend, what would be the top companies to watch?

Mr. Samana: Key companies in that area are going to be the traditional credit card companies as mobile payments encourage more transactions, and the technology pioneers that are actually developing the hardware and software would be other companies you should keep your eye on. So you are talking about **Apple**, **Samsung** (005930.KS), **Google** (GOOG), and the other mobile device manufacturers. The companies that provide a platform for mobile payments such as **Paypal** and **Venmo** could also benefit from the trend. **Google** is another example with Google Wallet. There will be multiple players that sit at the table as we look at the changes that happen in the mobile payment space, especially at least in the technology world.

TWST: Is there anything that we haven't talked about that you are following that you'd like to add to the conversation?

Mr. Samana: We continue to see a world where you have 2% to 3% IT spending growth, but there are pockets within that that investors should be focused on. The key themes there are Big Data analytics, cybersecurity, cloud-based software, and areas that relate to that because you are seeing a massive secular shift from traditional computing to cloud-based applications, the cloud infrastructure, next-generation data centers. We believe those themes have been the driving force for many companies over the last 12 to 24 months and will continue to do so for the next several years.

TWST: Thank you. (EP)

Note: Opinions and recommendations are as of 10/01/14.

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