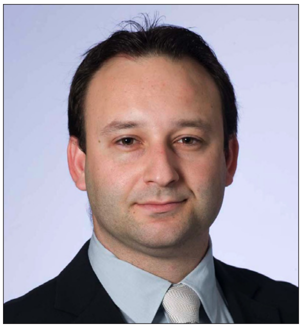
A N A L Y S T   I N T E R V I E W

Transition Phase Drives Enterprise Application Software Growth

ALEX ZUKIN — STEPHENS INC.



ALEX ZUKIN joined Stephens Inc. in 2012 and is currently a Research Analyst covering the enterprise software as a service segment out of the San Francisco office. He previously worked with Jonathan Ruykhaver covering infrastructure software. Prior to that, Mr. Zukin was a Vice President and Research Associate covering the infrastructure software sector for Morgan Keegan & Company, Inc. and ThinkEquity LLC. Mr. Zukin holds both a B.S. in business administration and a B.A in economics from the University of California, Berkeley.

SECTOR — MULTIMEDIA SOFTWARE

(AEU800) TWST: In which customer end markets do you think we will see the best demand for enterprise software solutions, and what is happening in those end markets to drive demand? Which of your companies are well-positioned to serve those markets?

Mr. Zukin: In terms of end customer demand, I don't think it's necessarily changing much. I think it's across verticals. I think it's across customer sizes. I think what I've seen from all of my companies is that almost all the companies that I cover are seeing larger deal sizes, are seeing more enterprise-size deals, are seeing greater acceptance at both the CIO level as well as the CEO level. And I think you're seeing even stalwarts like the financial services industry, a more highly regulated industry, start moving in that direction.

I think one area where you've seen a disruption, in particular, is e-commerce. Those customers have kind of been left, I'd say, trying to catch up to the technology disruption that they've seen, and I think the prevalence — the other common theme that I'm getting besides larger/more enterprise acceptance. One of the reasons that that's happening is the need for agility. Businesses need to be more nimble today more than ever, because otherwise they lose business, and the spending on these solutions from the companies that I cover is a fraction of the amount of business that they would lose basically if they weren't investing in these areas.

Highlights

Alex Zukin discusses his coverage of the enterprise software space. For enterprise software solutions, Mr. Zukin is seeing larger deal sizes, and he says that businesses have a need for more agility, which is driving more enterprise acceptance and spending in the area. He believes now is the time to buy these stocks at their current prices, especially for a growth investor, as the companies are growing due to the intense transition period in the software industry. Companies include: SAP AG (SAP); Adobe Systems (ADBE); Demandware (DWRE); Workday (WDAY); ServiceNow (NOW); Salesforce.com (CRM) and The Ultimate Software Group (ULTI).

TWST: What are the metrics you find most meaningful for analyzing the companies in your group that investors in the space should also analyze?

Mr. Zukin: I look at revenue growth, I look billings growth, I look at customer growth, I look at the lifetime value of a customer — that's very important to me. The core metric of an SaaS company: is effectively your lifetime value of your customer greater than your cost of customer acquisition over time? So for companies that are spending large percentages of their revenue on sales and marketing, what I want to see is that their growth rates are at least staying constant, and if they are accelerating it's even better.

But traditionally, if your cost of acquiring a customer is rising while your growth is slowing, then you're not setting yourself up to be a sustainable business, I think, in the long run. And the companies that I cover, in general I see either companies that are hyper-growth, 40%-plus, 35%-plus growth, or companies that have made the decision to be steady growth companies that have effectively created technology moats that are wide enough such that they can sustainably grow at 25% over time and still not be worried about other entrants coming into the market, and can maintain their sales and marketing spend as a percent of revenue at the kind of 20% to 25% level.

TWST: What additional information, data or color would you like to receive from management teams that most of them don't currently provide?

Mr. Zukin: One thing that I try to get from management teams is their level of confidence and visibility into the business. I find that when answers to questions are direct, when metrics are available, to me that demonstrates that there is really a level of confidence that the business is solid. I think for me, understanding the lifetime value metric, understanding if they're up-selling, cross-selling other products, if they are getting the larger share of the wallet for the customers that they are selling to, and getting more attention — or is the competitive environment changing or staying confident. Those are the kinds of the things that I try to hone in.

When I cover companies I try to identify the main themes that are driving the demand in the business, and then on the questions that I ask I basically try to hit on them. Has the messaging changed? Has the environment changed? If not, if it's the same, then are there any changes in the underlying themes?

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TWST: When you talk to management teams recently, what do they say is the most significant risk or challenge they are dealing with?

Mr. Zukin: Kind of going back toward my earlier point about seeing larger enterprise deals, larger enterprise focus, the two main challenges that I'm seeing and dealing with is execution from a sales perspective — so being able to change and hire the right sales people to sell a Fortune 500 to a Fortune 100 customer rather than a smaller customer that they're historically used to selling to. How do you manage both the transition in terms of culture and process, pipeline that is involved with that type of sale?

And the other thing that corresponds to that is the ability to effectively service that customer. How do you get the right ecosystem of partners involved to bring that customer onboard, integrate them in a timely efficient manner and then have the actual resources available to make sure that that customer is happy? Those are the two elements that I find our companies are dealing with. A lot these days that has to do with the fact that they are getting pulled into these larger deals that they've never seen before.

TWST: In your last interview with us, you said you expect to see continued M&A in this sector. What kinds of deals or even specific transactions are likely to happen that we should be watching out for?

Mr. Zukin: I think you've seen valuations expand dramatically in the space, and even over the next six months I would expect that sectors such as e-commerce that are in the middle of, I would say, higher disruption than others to see M&A. You saw **SAP** (SAP) acquire **Hybris** earlier in the year. We've heard that one of the other bidders in that deal was **Adobe** (ADBE). And I've said many times that I think that one of the companies that I cover, **Demandware** (DWRE), would be a logical takeout candidate for **Adobe**. I think that it would expand their market presence into a market that's under disruption and also be really interesting from the sense that it would partner content creators with the content distributors in an enterprise. So I would say from an M&A perspective that's probably the one I see as most likely.

TWST: Looking at the group as a whole, what are your thoughts on prices? Do we want to be buying these stocks at these prices?

Mr. Zukin: I think the way I answer that question — it's a question I get from investors on every meeting that I do — is you have to identify the winners, and if the markets are big enough, then the winners will correspondingly take a larger share of those markets over time. And I think that I use opportunistic pullbacks, market events to recommend adding to positions, but I would say generally yes.

These companies are growing and they are growing fast, and the reason they are growing fast is because the software industry is in a period of intense transition, and it's gone from the early-adopter phase to the general consensus of this is the right-way-forward phase. These are the companies that are smack in the middle of that trend, so if I'm a growth investor, I want to be owning these stocks. And to me it's also from a relative perspective. You see companies like **Workday** (WDAY) trading in excess of 20 times forward revenues, and you see companies like **ServiceNow** (NOW) trading at 14 or 15 times. To me, companies with similar end market sizes, similar growth rates, similar dollar sizes should trade at similar multiples.

TWST: Based on the dynamics of the sector and your outlook for your group, what kind of investor do you think would be most interested in enterprise Software-as-a-Service stocks in 2014?

Mr. Zukin: I think that the long-only guys that have really driven the core growth investments in this sector, it continues to be right for them. I think that in this sector in particular you get into virtuous cycles and vicious cycles where the winners win more and the losers don't necessarily catch up. And I've seen that play out in the sense of where there is an event, when you truly believe that a company is taking share, it is disrupting and is best-in-class.

1-Year Daily Chart of ServiceNow

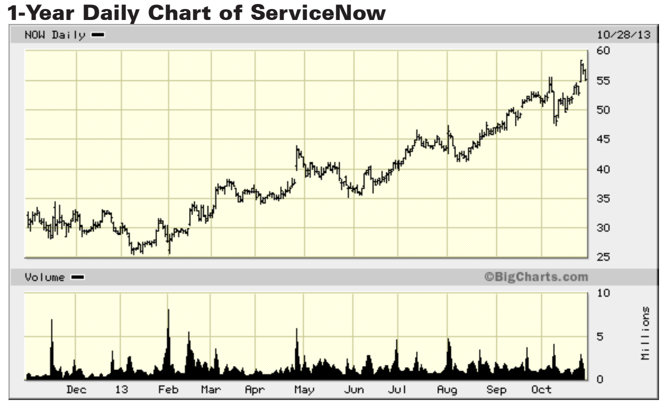

Chart provided by www.BigCharts.com

I would give an example. **Saleforce.com** (CRM), I believe that they are a true disruptor, best-in-class core growth opportunity. When that stock got hit over the summer, investor sentiment turned to, "Hey it looks this market is tapped out, the next leg of growth is going to be a lot lower." And the counter to that is that if you originally believe that this is a disruptor and this is a market leader, then the market size has to be a lot larger, and just because the company underperforms in a quarter does not necessarily mean that the story, the overarching theme and the story has changed. That's why I keep talking about the long-only investors. They are the ones I think that can benefit from those types of market gyrations and pick up great stories at a lower price point.

TWST: Which three stocks from your group would you recommend as best bets, and what do you like about each?

Mr. Zukin: I'd say that my top picks are probably going to be, I'd say **ServiceNow**. I think that that's a stock and a company that really is going after a much larger market opportunity than has historically been thought about. I think that they are not yet there with their platform offering in terms of figuring out how to properly position it and price it, but I think they are going to get there, and I think that when they do they are going to really see a very large market opportunity ahead of them. From the partners we've talked to it seems like there is just so much low-hanging fruit that's still yet to be automated, yet to be fully realized that not a lot of vendors are going after. So I think that's a company where they can maintain kind of industry-leading growth rates over the next couple of years.

Another company that I would talk about here is **Demandware**. I think **Demandware** really is positioned very well from being kind of the only pure-play SaaS vendor in that group benefiting from significant market transitions in the e-commerce sector. But more importantly you're seeing larger brands, as they go global, they can't support multiple sites and multiple geographies, and so they look to standardize on one vendor, and consequently they are putting more of their online revenues on the **Demandware** platform, which leads to I think better-than-expected revenue growth and billings growth for the foreseeable future for that one.

And finally in the human capital management space, **Ultimate Software** (ULTI), you've seen that stock trade up significantly over the last six months. I upgraded it in July based on the fact — I truly believe that they have a product that is best-in-class, they have a moat that is very wide, and they have chosen to grow at 25% consistently and only invest 20% to 25% of sales and marketing, and I think that model works, and I think growth investors are rewarding them for being able to grow sustainably and be profitable. I think that historically the knock on them has been this is not a growth company, and I don't think that's accurate in my view. I think that they are a steady growth company that has the luxury of being able to grow at its current pace and be profitable because of the competitive differentiation they've developed in their technology.

TWST: Thank you. (MES)

Note: Opinions and recommendations are as of 10/15/13.

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