# Technology & Communications

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Industry Brief

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**Application Software: Industry Tidbit**

## Private SaaS Company with $100+ Million in ARR Growing Over 40% and Profitable

iCIMS, a leading cloud-based provider of talent acquisition software solutions, announced 41% y/y revenue growth in 1Q16. This represents the 10th straight quarter the company has surpassed +30% y/y growth along with profitability. The company expects to grow revenues +30% while remaining cash flow positive and profitable for the full year 2016. Our research suggests the mid-market is experiencing strong greenfield adoption of talent acquisition software and iCIMS is also benefiting from competitive displacements of vendors who have been acquired in the past. We believe iCIMS' strong report reflects positively on the overall human capital management (HCM) group and names we cover on the public company side include Benefitfocus, Halogen Software, Paylocity, and Ultimate Software.

**Company Citations**

| Company Name | Ticker | Exchange | Currency | Closing Price | RJ Rating | RJ Entity |
|---|---|---|---|---|---|---|
| Benefitfocus, Inc. | BNFT | NASDAQ | $ | 37.92 | 1 | RJ & Associates |
| Halogen Software, Inc. | HGN | TSX | C$ | 8.30 | 2 | RJ & Associates |
| Paylocity Holding Corporation | PCTY | NASDAQ | $ | 38.58 | 2 | RJ & Associates |
| Ultimate Software Group Inc. | ULTI | NASDAQ | $ | 197.64 | 2 | RJ & Associates |

Notes: Prices are as of the most recent close on the indicated exchange and may not be in US$. See Disclosure section for rating definitions. Stocks that do not trade on a U.S. national exchange may not be registered for sale in all U.S. states. NC=not covered.

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|---|---|---|---|---|---|---|---|---|
| | RJA | RJL | RJ Arg | RJEE/RJFI | RJA | RJL | RJ Arg | RJEE/RJFI |
| **Strong Buy and Outperform (Buy)** | 55% | 66% | 53% | 47% | 18% | 42% | 0% | 0% |
| **Market Perform (Hold)** | 39% | 31% | 47% | 39% | 5% | 14% | 0% | 0% |
| **Underperform (Sell)** | 6% | 3% | 0% | 14% | 7% | 0% | 0% | 0% |

* Columns may not add to 100% due to rounding.

**Suitability Ratings (SR)**

**Medium Risk/Income (M/INC)** Lower to average risk equities of companies with sound financials, consistent earnings, and dividend yields above that of the S&P 500. Many securities in this category are structured with a focus on providing a consistent dividend or return of capital.

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**High Risk/Growth (H/GRW)** Medium to higher risk equities of companies in fast growing and competitive industries, with less predictable earnings (or losses), more leveraged balance sheets, rapidly changing market dynamics, financial or legal issues, higher price volatility (beta), and potential risk of principal.

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**Specific Investment Risks Related to the Industry or Issuer**

**Application Software Industry Risk Factors**

**Early-Stage Growth Presents Challenges and Opportunities**
We believe many of the publicly traded SaaS applications vendors remain early in monetizing their respective growth opportunities. We anticipate continued rapid investment in required infrastructure, such as data center operations, in order to address growing customer transaction volumes and geographic expansion, sales and marketing build out to better serve both lower end and enterprise market opportunities, and general and administrative investments in order to enhance internal finance, human resources, legal, and IT processes to handle rapid growth. Such expenses, along with required capital expenditures, could hamper earnings leverage over the intermediate term, and/or create volatile cash flow performance.

**Measuring the Size of SaaS Markets**
It is evident that SaaS represents a secular growth opportunity in an otherwise slower growing, cyclical enterprise software market. Many of the publicly traded SaaS vendors have achieved robust growth, in a number of cases exceeding 30%-plus in revenue, and have experienced a strong uptick in cash flow. Industry forecasts suggest that this strong relative growth will persist highlighted by in excess of 5x the growth of more traditional applications software market over a long-term basis. While it is clear that the relative growth of SaaS markets will remain pronounced, the slope of the growth curve could prove less steep, adoption rates could prove uneven, and SaaS markets could prove less recession-resilient that many anticipate. Slower-than-expected growth in SaaS markets could impact profitability, especially for many of the SaaS vendors that remain focused on rapid investment and maximizing top-line growth and bookings at the expense of near-term profitability.

**Complexity in Financial Model**
With SaaS vendors, we believe there is greater financial complexity versus the typical enterprise software license model. The SaaS, on-demand model encompasses upfront costs associated with gaining business and delivering services; however, associated revenue is spread out ratably over the life of the contract in the form of subscription revenue. Understanding the true quarter-to-quarter success in new customer sales requires a focus on various metrics, such as billings, bookings, backlog, etc. While deferred revenue can sometimes represent a solid proxy for measuring quarterly sales success, it is not an absolute metric and can often exclude off-balance-sheet contracted backlog that has not yet been invoiced. Furthermore, renewal characteristics from the installed base are difficult to measure and investors and the Street are typically at the mercy of company management to get updates on key metrics like bookings, backlog, renewal rates, average deal size, contract duration, etc. Unfortunately, these metrics can be inconsistently provided or not provided at all. Lastly, another complicating factor is the fact that no two SaaS vendors have identical methods for invoicing new sales (e.g., some may invoice annually, others quarterly or

monthly) and accounting practices in areas like sales commissions and capitalized software; thus, apples-to-apples comparisons on a variety of items like profitability and cash flows can vary dramatically.

**Data Protection, Privacy, and Performance Concerns**

Our checks indicate SaaS vendors are making aggressive steps to minimize customer and prospect concerns over the protection of key company information (e.g., customer records, key profit and loss data, compliance information, etc.). Such steps include heightened investment in SaaS infrastructure such as redundant server hardware, grid computing, virtualization, encryption, and data management technologies. Still, data protection and privacy concerns will remain a relevant issue and could represent a gaiting factor in some vertical markets, like financial services, whereby sensitivity to customer data is paramount. Independent of perceived data protection issues, SaaS vendors must continue to gain confidence from their customers that the underlying SaaS applications will maintain high levels of performance reliability.

**Technology & Communications Risks**

Industry risks include customer concentration, product cycle delays, softer than expected North American capital investments in 2015, the potential slowing of specific initiatives such as 4G/LTE, and the potential revenue impact from the migration to SDN (software defined network) and NFV (network function virtualization) technologies.

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