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3-SIGMA VALUE

Polishing Turd – Part 2

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In 2012, I published an analysis of Jive Software (JIVE) called "Polishing Turd". Originally published in Chapter 3 of Software Economics – Volume II, it is available at www.3sigmavalue.com.

JIVE sells workplace collaboration software that increases productivity, produces fewer emails, and overall lowers cost. The problem is that workplace collaboration software is already the most popular and commoditized SaaS application (by function) with low complexity and low IP value. Moreover, competition is free/freemium and fierce. Salesforce.com's Chatter is offered for free, at the entry level. Microsoft's sells Yammer and Sharepoint, integrated with Dynamics. IBM's enterprise collaboration products include Lotus Quikr and Lotus Live, in addition to IBM Connections products. Google, EMC/Documentum, H-P, ServiceNow, Zendesk, and TIBCO (TIBX) all offer collaboration software, in most cases giving it away to customers at no incremental cost.

The latest flavor of collaboration software is sold by an Australian-based developer called Atlassian that went public on 12/8/15 @ $21 per share with the clever ticker TEAM. TEAM sells collaboration software that was originally designed for software development teams but has since expanded to other areas of the enterprise including marketing, operations, and HR. 75% of 2015 bookings were on-premise and 25% SaaS; however, according to the company, ~80% of new customers are choosing SaaS (a curious inflection).

TEAM does not have a traditional direct sales force; instead, 98% of sales are transacted through TEAM's website, including the ~25% sold through indirect channels, which are focused on regions where there are language barriers. As a result, S&M as a % of revenue is at the low end of its peers. The savings on S&M enables a higher level of R&D (R&D ~40% of revenue).

TEAM's products include: (1) Jira (~50% of sales) – software for tracking and managing tasks/projects, mainly used by developers tracking bugs in software. IBM Rational and Connections, Microsoft Project, CA VersionOne and Rally, SAP, and H-P all offer comparable products. (2) Confluence (~30% of sales) – document collaboration software used by intranet pages or the IT department creating how-to reference pages. Competes against Microsoft

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SharePoint, Google Docs/Drive, etc. (3) HipChat (<5% of sales) – real time collaboration and messaging; competes mainly against Microsoft Skype for Business (Lync), VMWare's SocialCast, Slack, Concerto, and Asana (Justin Moskowitz). (4) Jira Service Desk (<5% of sales) – new derivation of Jira that competes against ServiceNow (NOW), CA, IBM, H-P, and BMC (Bain LBO at 3.1x / 9.6x revenue/EBITDA in 2013).

While TEAM spends on R&D as much as any software company in our universe, the core tenet of its business strategy – to sell software without a direct sales force – is flawed if TEAM wants to expand up-market and across the enterprise where direct sales is necessary. If not, then growth will stagnate and TEAM’s valuation will compress. Ultimately, TEAM will be compelled to build-out a salesforce, ending any hope of operating leverage.

In determining the quality of a technology business, we quantify using four factors:

(1) Gross Margin (GM) – shows how much technology content is in each sale. A lower gross margin means the vendor is paying someone else, generally in the form of a license or royalty. The most efficient technology companies that develop all of their IP in-house report gross margins above 90%. On the other end of the spectrum, vendors that license or pay royalties on technology developed elsewhere report gross margins closer to 60%. TEAM’s gross margin is a solid 83%, reflecting in-house IP.

(2) Cumulative R&D / R&D as a % of Revenue + Cumulative Capex / Capex as a % of Revenue – signals the value of the underlying intellectual property (IP). While plenty of companies waste money developing technologies that don’t work or aren’t wanted, if a company doesn’t spend any money at all on research and development (R&D) then how can it purport to be a technology company? TEAM spend 46% on R&D in the most recent quarter (1Q 2016), equating to $54 million and growing. This is a tremendous investment in technology, but one that is dependent on a similarly-tremendous under-investment in sales.

(3) Operating Margin (OM) – shows how efficiently a company is managed. Technology is scalable and the cost of technology deflationary due to innovation and Moore’s Law. R&D expenses tend to be relatively consistent over time while operating leverage is earned in sales and marketing (S&M), and general and administrative (G&A) to a lesser extent. This is where TEAM’s business model breaks down. Despite under-investing in S&M, TEAM still does not

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make money. EBIT is negative while D&A pushes EBITDA above breakeven in 2017. This is low quality EBITDA.

(4) Ultimately, cash is what matters, not earnings. 2016E EBITDA ~ zero translates into free cash flow of approx. $65 million, entirely due to $70 million of stock compensation. In our Base Case Operating Scenario 1, we assume TEAM adds approximately 10,000 net clients each year. In this scenario, EBITDA grows to $45 million (90.6x EBITDA) in 2018 with FCF ~$100 million.

TEAM Capitalization as of 3/31/16	
Price at December 9, 2014 IPO	**$21.00**
Price at end of 1st day	**$27.78**
Price as of May 31, 2016	**$22.57**
FD Shares Outstanding	212,920
Market Capitalization	**4,805,604**
Debt	0
Cash & Equivalents	723,275
Enterprise Value (EV)	**4,082,329**
EV / Revenue - 2015	10.5x
EV / Revenue - 2016E	8.0x
EV / Revenue - 2017E	6.8x
EV / Revenue - 2018E	5.9x

Short Thesis

1. Competition is overwhelming as comparable/better collaboration products are offered by MSFT SharePoint, CRM Chatter, GOOG, IBM, HPQ, etc.

2. Jira is old, on-premise software that was released in 2002. Confluence was launched in 2004 also for on-premise deployments. Jira and Confluence are widely acknowledged not to be best-in-breed.

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3. Mission-oriented marketing emphasizes culture while de-emphasizing technology. A red flag is raised when employees are referred to as something other than employees; in this case they are Atlassians. See their website for promotional videos that say nothing about the product.

4. TEAM will have to build-out a sales force if it wants to compete for business across the enterprise. Reality will eventually crush the mission of the company, which is to "*set conventional wisdom on its ear by launching a successful enterprise software company with no sales force.*"

5. Valuation is irrationally exuberant, especially given no meaningful EBIT, EBITDA or EPS through 2018 at the earliest.

<u>Valuation Analysis</u>

We identify the significant assumptions (factors) underlying our analysis of Atlassian (TEAM):

1. Net new customers – 2016 guidance implies flattish customer additions ~ 3,000 per quarter; range = 6,000-14,000 per year. The midpoint is lower than 2016 guidance because after saturating its core mid-market, TEAM is moving upstream to fewer but larger customers.

2. Revenue per customer – 2016 guidance implies flattish ARPU; cross-selling is offset by deflationary forces. Range = 0%-10%.

3. Gross margin – flattish around LQA ~ 83%. Minor accretion/dilution in the upside/downside cases.

4. Operating Expenses
    a. R&D – increasing $2 million to $10 million per quarter (upside/downside).

    b. S&M – flattish around LQA; no operating leverage. Downside cases assume TEAM begins building a direct sales force in 2017/2018.

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c. G&A – Upside is flattish around LQA; downside is LQA as a % of revenues, reflecting no operating leverage; base cases are in between.

d. Stock compensation – flattish in connection with a stagnant stock price; base = rolling avg. LTM.

5. Capital expenditures – approx. $50 million per year is an estimate based on management commentary.

6. WACC = 10% / Terminal Value Multiple = range of 10x (downside) to 25x EBITDA (upside).

M&A Comps - Systems & Data Management Software

Target	Acquirer	Date	Valuation	Revenue	EBITDA
Qlik Technologies (QLIK)	Thoma Bravo	Jun-16	2,700	3.4x	NM
Informatica (INFA)	Permira, CPPIB	Apr-15	5,300	4.6x	25.5x
Tibco Software (TIBX)	Vista Equity	Sep-14	4,300	4.0x	18.0x
Compuware (CPWR)	Thoma Bravo	Sep-14	2,500	3.4x	22.5x
BMC Software (BMC)	Bain and G. Gate	May-13	6,900	3.1x	9.6x
Quest Software (QSFT)	Dell	Mar-12	2,400	2.6x	8.6x
Average				**3.5x**	**16.8x**

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Atlassian (TEAM) Financial Summary - Base Case Operating Scenario 1					
CYE	2014	2015	2016	2017	2018
Paid Customers - start of period		42,800	54,262	66,431	76,431
Net New Customers		11,462	12,169	10,000	10,000
Paid Customers - end of period		54,262	66,431	76,431	86,431
% Growth			22%	15%	13%
Paid Customers - average		48,531	60,347	71,431	81,431
Revenue Per Customer		7.98	8.46	8.46	8.46
% Growth			6.0%	0.0%	0.0%
Other	7,782	15,884	30,399	36,572	41,691
% of Revenue	3.6%	4.1%	6.0%	6.1%	6.1%
Total Revenue	**215,109**	**387,338**	**510,317**	**604,053**	**688,618**
% Growth		**80.1%**	**31.7%**	**18.4%**	**14.0%**
Deferred Revenue	89,200	136,500	175,528	212,099	253,791
Change in Deferred Revenue		47,300	39,028	36,572	41,691
Bookings	304,309	523,838	685,845	640,625	730,309
Cost of Revenue	37,986	63,625	85,516	101,224	115,394
Gross Profit	**177,123**	**323,713**	**424,802**	**502,830**	**573,223**
% Margin	**82.3%**	**83.6%**	**83.2%**	**83.2%**	**83.2%**
Operating Expenses					
R&D	78,640	173,391	252,680	276,680	300,680
as a % of Revenue	36.6%	44.8%	49.5%	45.8%	43.7%
S&M	34,968	76,979	105,731	125,152	142,672
as a % of Revenue	16.3%	19.9%	20.7%	20.7%	20.7%
G&A	41,984	68,246	101,966	113,248	119,314
as a % of Revenue	19.5%	17.6%	20.0%	18.7%	17.3%
Total Opex	155,592	318,616	460,377	515,080	562,666
as a % of Revenue	72.3%	82.3%	90.2%	85.3%	81.7%
EBIT	**21,531**	**5,097**	**-35,575**	**-12,250**	**10,557**
+ D&A	**7,139**	**17,719**	**24,496**	**29,496**	**34,496**
= EBITDA	**28,670**	**22,816**	**-11,080**	**17,245**	**45,053**
Other Income (Expense)	697	-692	752	752	752
Pre-tax Income	22,228	4,405	-34,823	-11,498	11,309
Taxes	3,246	1,149	-3,111	0	0
% Rate	14.6%	26.1%	0.0%	0.0%	0.0%
Net Income	18,982	3,256	-31,712	-11,498	11,309
NOPAT	18,387	3,767	-35,575	-12,250	10,557
+ D&A	13,316	17,719	24,496	29,496	34,496
+ Stock Comp	11,364	41,534	70,801	70,801	70,801
as a % of Revenue	5.3%	10.7%	13.9%	11.7%	10.3%
+/- Change in WC	6,283	-1,765	10,924	0	0
+/- Change in Deferred Revenue	24,785	47,381	39,028	36,572	41,691
- Capex	-8,110	-27,126	-43,812	-50,000	-50,000
= Free Cash Flow	**62,992**	**82,840**	**65,861**	**74,618**	**107,545**

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On a probability-weighted basis, TEAM is worth $8.75 per share (down 61.2%), which is equivalent to 3.8x 2018 revenue, a premium to the 3.5x paid in comparable M&A transactions.

Atlassian (TEAM - Valuation Sumamry						
	Live	Upside	Base 1	Base 2	Base 3	Downside
WACC	10%					
Net New Customers - 2018	10,000	14,000	12,000	10,000	8,000	6,000
Revenue	688,618	745,581	713,987	688,618	663,248	629,607
EBITDA	45,053	157,954	58,468	45,053	31,638	-59,354
Free Cash Flow	107,545	223,895	122,496	107,545	92,594	-435
PV of UCFC (2016-2018)	202,341	375,806	217,669	202,341	187,013	41,331
Terminal Value Multiple (10x-20x)	16.8x	25.0x	16.8x	16.8x	16.8x	10.0x
Terminal Valuation	568,661	2,966,830	737,989	568,661	399,333	0
Net Cash (Debt)	723,275	723,275	723,275	723,275	723,275	723,275
Equity Value	1,494,277	4,065,911	1,678,932	1,494,277	1,309,621	764,606
per share	7.02	19.10	7.89	7.02	6.15	3.59
Implied Multiple of 2018 Revenue	3.2x	6.2x	3.1x	3.1x	3.1x	1.6x
Probability		20%	20%	20%	20%	20%
Prob-weighted target price	**$8.75**	3.82	1.58	1.40	1.23	0.72
Upside (Downside)	**-61.2%**					
Implied Multiple of 2018 Revenue	**3.8x**					
Implied Multiple of 2018 EBITDA	**57.4x**					

Upside Analysis (Quantifying the Risk)

In an Upside Case operating scenario, in which revenue per customer increases 10% per annum and net new clients rises to 4,000 per q (up from 3,000), EBITDA jumps to $275 million in 2018, producing $350 million of free cash flow. Furthermore, we apply a premium take-out multiple of 25x EBITDA to the Upside Case scenario, incorporating the potential upside from a take-out into the valuation. Upside equity value per share = $30.07.

Finally, we are highly cognizant of the risk of a short-squeeze. We assess potential short squeeze risk in terms of the number of days to cover (11 days). This is a benign number. Over 30 days signals a high degree of short squeeze risk; 15 to 30 days represents moderate risk; below 15 represents low risk.

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