IPO ANALYSIS

Research on potential upcoming IPOs for selected candidate companies.

Spotify

Smartsheet

DocuSign

April 2018

VentureDeal

Spotify Readies U.S. Direct Listing IPO

Direct Listing

Spotify's (SPOT) direct listing IPO is scheduled to begin trading Tuesday, April 3, 2018, according to its most recent F-1/A registration statement.

SPOT provides listeners with streaming music and podcast entertainment via its popular global platform.

The firm's business model is a combination of both advertising-supported streaming and premium subscription revenue-based access.

Management is pursuing a direct listing through the NYSE, bypassing traditional IPO processes that are mediated by underwriters and bookrunners.

This will allow the firm to sell (transfer) ordinary shares from existing shareholders directly to the public using the NYSE as an ostensible market maker.

The firm will receive no proceeds from the sale of shares and the total number of shares to be sold is not a set figure.

The advantages of this type of issuance are that the firm can avoid lengthy roadshows and underwriter expenses while presumably making its shares available to a wider swath of investors. Management believes this is a fairer approach as well as dovetailing conveniently with its desire to reach as many users in the lucrative U.S. market.

The disadvantages of this approach are that although the NYSE will act as the transfer agent for the shares, there will be no market stabilization capabilities which are typically undertaken by traditional IPO bookrunners and underwriters. Additionally, initial price discovery will be more uncertain, since bookrunners typically provide management with investor feedback on pricing during the typical pre-IPO roadshow.

Company Guidance

Spotify's management has more recently published its financial outlook for Q1 and full year 2018.

Notably, the firm forecasts full-year 2018 total revenue growth of between **20% - 30%**. If SPOT achieves this growth rate, it will represent a further slowing of topline revenue growth rates from previous years, as the recap below indicates:

- 2017: $4.99 billion, 38.6% increase vs. prior
- 2016: $3.6 billion, 52% increase vs. prior
- 2015: $2.37 billion, 78% increase vs. prior
- 2014: $1.33 billion, 46% increase vs. prior
- 2013: $911 million

(Source: F-1 and IPO Edge)

Additionally, management expects the Euro to fall against the dollar during 2018, as evidenced by its statement, 'We anticipate changes in foreign exchange rates will have a negative impact of approximately EUR260 - 300 million for the full year.'

That is a fairly significant impact, approximately 5.8% reduction in topline revenue since its full-year guidance midpoint is EUR5.2 billion.

On a positive note, Gross Margin is expected to be in the range of 23% - 25%, which would represent a continued improvement compared to previous years shown below:

- 2017: 20.7%
- 2016: 13.6%
- 2015: 11.6%
- 2014: 16%
- 2013: 17%

Market Volatility

In addition to the uncertainty caused by a lack of proposed pricing range with Spotify's direct listing approach, the risk to SPOT investors is overall market volatility as shown in the VIX chart below:

(Source: StockCharts)

After a quiet 2017, overall market volatility has risen markedly since the end of January, owing to a number of macroeconomic and geopolitical uncertainties.

Volatility is the enemy of a smoothly functioning IPO market as it makes valuing new issues, which tend to be riskier, more difficult.

Using a wider lens, management has admitted that it expects initial trading to have the potential to be more volatile:

... the listing of our ordinary shares on the NYSE without underwriters is a novel method for commencing public trading in our ordinary shares, and consequently, the trading volume and price of our ordinary shares may be more volatile than if our ordinary shares were initially listed in connection with an underwritten initial public offering.

(Source: SPOT F-1/A)

Valuation

Since management hasn't provided a proposed price range for the direct listing and due to the uncertainty of the direct listing process itself, coming to a firm opinion on valuation can be tricky.

The firm has provided a recent history of its share price activity in private, secondary markets in 2017, as the table below shows:

	Fair market value
February	$ 50.70
May	$ 65.50
June	$ 69.03
August	$ 78.25
September	$ 87.68
November	$ 90.65
December	$ 120.50

(Source: Spotify F-1/A)

Notably, the December 2017 price indicated more than double the price in February 2017. I find this change difficult to fathom on a fundamentals basis, as it is unlikely that the value of the firm's underlying business more than doubled in value in only ten months.

I wonder if the price run-up was more a function of expectations of an IPO in the near future driving demand for short-term 'flip' opportunities by late-stage institutional investors.

If so, that potential short-term speculation aspect combined with the fact that there are no lockups requiring existing shareholders to avoid selling into the direct listing (not including TME and Tencent shareholders), could result in significant downward pricing pressure in the hours or days immediately following the IPO.

In fact, management has outlined this very scenario in its filing:

None of our Registered Shareholders or other existing shareholders have entered into contractual lock-up agreements or other contractual restrictions on transfer, except for TME and Tencent. In an underwritten initial public offering, it is customary for an issuer's officers, directors, and most of its other shareholders to enter into a 180 day contractual lock-up arrangement with the underwriters to help promote orderly trading immediately after listing. Consequently, any of our shareholders, including our directors and officers who own our ordinary shares and other significant shareholders, may sell any or all of their ordinary shares at any time (subject to any restrictions under applicable law), including immediately upon listing. If such sales were to occur in a significant quantum, it may result in an oversupply of our ordinary shares in the market, which could adversely impact the public price of our ordinary shares.

As to valuation, I will take this opportunity to defer to the ultimate valuation guru, NYU Stern professor Aswath Damodaran. His detailed analysis puts the full value per share at $115.31.

Damodaran highlights the main points of SPOT's financial metrics, namely slowing revenue growth, decreased content costs but increased other costs such as R&D, Selling & Marketing and G&A.

Below is his valuation worksheet where he comes to a value of EUR93.40 ($115.31) per share:

Spotify

The Story

Spotify is the world's largest conduit for streaming music, which has become the dominant form of downloads in the music business. Spotify will continue to add users, though at a slower rate, as it faces strong competition in the US from Apple Music and scaling up issues, and shift increasingly to a subscriber based business, away from advertising. As the user base grows, the operating margins, currently negative, will improve as content costs continue to shrink and economies of scale bring other costs under control. As a money-losing company facing deep-pocketed competition, there is a 20% chance that the company will be forced to sell itself at half its fair value sometime in the next 10 years.

The Assumptions

	Base year	*Years 1-5*	*Years 6-10*		*After year 10*	*Link to story*
Revenues (a)	$ 4,090	25.00%	2.85%		2.85%	User growth continues, albeit at slower pace, with shift towards subscription-based model.
Operating margin (b)	-3.75%	-3.75%	12.97%		12.97%	Content costs will continue to drop, as Spotify negotiates better deals with music labels. Economies of scale will lower G&A and R&D costs.
Tax rate	25.00%	25.00%	25.00%		25.00%	Used a global average tax rate. Used NOL of 1.35 billion Euros to defer paying taxes until year 6.
Reinvestment (c)		Sales to capital ratio	4.00	RIR =	23.75%	Low capital intensity business with technology and platform investments taking the form of R&D.
Return on capital	-88.99%	Marginal ROIC =	67.55%		12.00%	
Cost of capital (d)		9.24%	7.35%		7.35%	

The Cash Flows

	Revenues	*Operating Margin*	*EBIT*	*EBIT (1-t)*	*Reinvestment*	*FCFF*
1	€ 5,112.50	-2.08%	€ (106.38)	€ (106.38)	€ 255.63	€ (362.01)
2	€ 6,390.63	-0.41%	€ (26.11)	€ (26.11)	€ 319.53	€ (345.64)
3	€ 7,988.28	1.26%	€ 100.95	€ 100.95	€ 399.41	€ (298.46)
4	€ 9,985.35	2.94%	€ 293.17	€ 293.17	€ 499.27	€ (206.10)
5	€ 12,481.69	4.61%	€ 575.19	€ 575.19	€ 624.08	€ (48.90)
6	€ 15,049.17	6.28%	€ 945.16	€ 837.42	€ 641.87	€ 195.55
7	€ 17,478.11	7.95%	€ 1,389.99	€ 1,042.49	€ 607.23	€ 435.26
8	€ 19,524.80	9.63%	€ 1,879.27	€ 1,409.45	€ 511.67	€ 897.78
9	€ 20,946.20	11.30%	€ 2,366.35	€ 1,774.76	€ 355.35	€ 1,419.41
10	€ 21,543.17	12.97%	€ 2,794.05	€ 2,095.54	€ 149.24	€ 1,946.30
Terminal year	€ 22,157.15	12.97%	€ 2,873.68	€ 2,155.26	€ 511.87	€ 1,643.39

The Value

Terminal value	€ 36,519.70		
PV(Terminal value)	€ 15,902.66		
PV (CF over next 10 years)	€ 1,289.39		
Value of operating assets =	€ 17,192.05		
Adjustment for distress	€ 1,719.20	Probability of failure =	20.00%
- Debt & Mnority Interests	€ -		
+ Cash & Other Non-operating assets	€ 2,419.00	Include a cross holding of 910 million Euros in Tencent Music	
Value of equity	€ 17,891.84		
- Value of equity options	€ 1,344.28		
Number of shares	177.17		
Value per share	€ 93.40	Most Recent VC Pricing =	€ 107.33

(Source: Aswath Damodaran)

On one aspect, I disagree with his assumption about SPOT's future revenue mix shifting to a more subscription-based model.

I believe that it will shift to a more advertising-based model since its largest penetration to-date has been in the developed, wealthy nations who can afford subscriptions. Future market expansion will include less-developed regions which are more price-sensitive and in my view will stay with the free, ad-supported version rather than pay for avoiding commercials.

Commentary

Spotify's direct listing offering will receive significant press coverage on Monday. Given that the firm provides a well-known, consumer-oriented service, it is likely that the IPO will receive enough attention to succeed.

As I see it, the question for investors is whether you wish to play in the IPO or its immediate aftermath or wait until the 'dust settles' for a few days to see where the shares trade later in the week.

If we assume initial pricing of the listing is around $115.00, that would indicate the shares are fully valued based on current information if you take Damodaran's valuation analysis at face value.

Accordingly, I would use the $115.00 figure as a 'do not cross' line in which to gauge desirability of SPOT shares in early days of trading.

Furthermore, my own preference would be to avoid the initial volatility and wait until later in the week to determine an entry point, subject to potential early trading price drops if they are significantly below $115.00.

In other words, I believe interested investors would be well-served by taking a wait-and-see approach to initial trading action, which may see existing and recent new shareholders selling large positions thereby creating potential improved entry points.

Above $115.00, investors are on their own as to whether they wish to initiate a position above the presumed full value of the shares based on current information.

Smartsheet Files For $100 Million U.S. IPO

Quick Take

Smartsheet (Pending:SMAR) intends to raise $100 million in an IPO, according to an S-1 registration statement.

The firm has developed a suite of collaboration tools for enterprise teams across numerous functions to more efficiently accomplish their work product goals.

SMAR is growing quickly but isn't showing the path to profitability that one would expect from a top SaaS candidate.

I'll provide a final opinion when we learn management's pricing and valuation assumptions.

Company & Technology

Bellevue, Washington-based Smartsheet was founded in 2005 to 'build a universal application for work management that does not require coding capabilities.'

Management is headed by President and CEO Mark Mader, who has been with the firm since 2006 and previously held various leadership positions at Onyx Software.

Smartsheet has developed a robust channel partner program as well as a significant list of integrations with major platforms and relevant services that extend its capability into existing enterprise workflow systems.

The firm's investors include venture capital firms such as Insight Ventures (32.1% pre-IPO stake), Madrona Ventures (28.4%) and Sutter Hill Ventures (5.4%). Investment received to-date totals approximately $138.6 million.

Smartsheet has created a suite of spreadsheet-like modules for various company functions including:

- Customer Service

- Project Management
- Business Process
- Marketing
- Budget & Planning
- Facilities Management

Customer Acquisition

Smartsheet sells its subscription service via an 'unassisted' self-serve model on its website as well as through inside sales and a field sales team for higher value enterprise selling.

Management says the 'blended go-to-market model allows us to serve a larger, diverse user base without incurring excessive costs.'

Smartsheet claims more than 92,000 customers, with 90 of the Fortune 100 and ⅔ of Fortune 500 customers.

Customer acquisition cost trends are as follows:

Total Cost of Revenue (%)

- FYE 2018: 19.5%
- FYE 2017: 21.0%
- FYE 2016: 21.0%

Sales and marketing expense as a percentage of Total revenue (%)

- FYE 2018: 65.5%
- FYE 2017: 59.7%
- FYE 2016: 69.6%

So, the firm is gradually reducing its Cost of Revenue percentage but its Sales and marketing expenses as a percentage of Total revenue have been uneven and for two of the last three years well within the range of 65% - 70%.

This indicates a potential higher Sales and marketing expense trend as a percentage associated with growth in revenues, suggesting that as the firm grows, it is becoming less efficient in its Sales and marketing efforts.

Market

According to a market research report by [MarketsandMarkets](), the business process management market is expected to reach $13.52 billion by 2021, representing a CAGR of 14.2% from 2016.

The SME segment is forecasted to grow the fastest of any subgroup in the report due to their desire to 'achieve better operational productivity' and lower their 'operational costs' associated with that productivity enhancement.

North America is expected to contribute the largest demand while the APAC region will provide substantial growth opportunities.

Competition

Major competitive vendors that provide similar software in terms of end-user needs include:

- Appian (APPN)
- IBM (IBM)
- Software AG (OTC:SWDAF)
- Oracle (ORCL)
- Pegasystems (PEGA)
- Redhat (RHAT)
- OpenText (OTEX)
- Tibco Software
- Verisae
- Asana
- Workfront
- Atlassian (TEAM)
- Planview

Financials

SMAR's recent financial results can be summarized as follows:

- Strong topline revenue increase
- Increasing gross profit dollars
- Slightly increasing gross margin percentage
- Uneven cash flow used in or from operations

Below are the company's operational results for the past three years (Audited GAAP):

	Year Ended January 31,		
	2016	2017	2018
	(in thousands, except per share data)		
Consolidated Statements of Operations Data:			
Revenue			
Subscription	$ 39,568	$ 62,416	$ 100,368
Professional services	1,183	4,548	10,885
Total revenue	40,751	66,964	111,253
Cost of revenue			
Subscription(1)	6,961	10,117	13,008
Professional services(1)	1,636	4,016	8,674
Total cost of revenue	8,597	14,133	21,682
Gross profit	32,154	52,831	89,571
Operating expenses			
Research and development(1)	12,900	19,640	37,590
Sales and marketing(1)	28,440	40,071	72,925
General and administrative(1)	5,163	8,275	28,034
Total operating expenses	46,503	67,986	138,549
Loss from operations	(14,349)	(15,155)	(48,978)
Interest expense and other, net	—	(29)	(435)
Net loss before provision (benefit) for income taxes	(14,349)	(15,184)	(49,413)
Provision (benefit) for income taxes	—	—	(307)
Net loss	(14,349)	(15,184)	(49,106)

(Source: Smartsheet S-1)

Revenue ($)

- FYE 2018: $111.3 million, 66% increase vs. prior
- FYE 2017: $67 million, 64% increase vs. prior
- FYE 2016: $40.8 million

Gross Profit ($)

- FYE 2018: $89.6 million
- FYE 2017: $52.8 million
- FYE 2016: $32.2 million

Gross Margin (%)

- FYE 2018: 80.5%
- FYE 2017: 78.8%
- FYE 2016: 78.9%

Cash Flow from Operations ($)

- FYE 2018: $13.6 million cash used in operations

- FYE 2017: $58,000 cash flow from operations
- FYE 2016: $6.7 million cash used in operations

As of January 31, 2018, the company had $58 million in cash and $84.7 million in total liabilities.

IPO Details

SMAR intends to raise $100 million in gross proceeds from an IPO of its Class A common stock.

The IPO will offer Class A shares, which will be entitled to one vote per share vs. ten votes per share for Class B shares.

Multiple share classes are a way for existing management and shareholders to retain voting control even if it loses economic control of the company in the future.

The S&P 500 Index no longer admits firms that have multiple share classes.

Management says it will use the net proceeds from the IPO as follows:

The principal purposes of this offering are to increase our capitalization and financial flexibility, create a public market for our Class A common stock, and facilitate future access to the public equity markets for us and our shareholders.

This is boilerplate language that effectively says nothing meaningful about how management intends to use the proceeds from the IPO.

Management's presentation of the company roadshow is not yet available.

Listed bookrunners of the IPO are Morgan Stanley, J.P. Morgan, Jefferies, RBC Capital Markets, Canaccord Genuity, William Blair and SunTrust Robinson Humphrey.

Commentary

Smartsheet aims to provide a low-cost, modular approach to collaboration and enterprise functional operations software using the familiar spreadsheet as a basis for its user interface.

When users ask for technical help less often, it leads to reduced support infrastructure and costs and more productive users.

SMAR's financial results have been impressive in parts as the firm has sold its suite to all levels of the marketplace.

Topline revenues have been growing at an increasing rate, the firm's net $ retention rate stands at a healthy 130% and gross margins are high.

Two areas of concern are a potential increasing trend in Sales and marketing costs as a percentage of total revenue and an increased cash burn rate in FYE 2018.

Taken together, these two factors could be a sign that management is spending an increased amount to generate a marginal dollar of sales.

Another financial area of concern is the dramatically increased R&D and G&A costs in FYE 2018, which have resulted in a terrible Net Loss of well more than both the two previous year's losses combined.

So, although the firm has an enviable growth trajectory which is critical for a successful IPO, management isn't showing a path to profitability in return for its likely high valuation expectations in the current market environment.

Valuation and pricing of the IPO will be critical and I look forward to providing a final opinion when we learn those details.

Expected IPO Pricing Date: Not on calendar.

DocuSign Aims For 2018 IPO

Quick Take

DocuSign (DOCU) (ESIGN) intends to raise $100 million in an IPO of its common stock, according to an S-1 registration statement.

The firm provides a suite of online software services for e-signature and related document management for businesses and individuals.

DOCU is growing quickly although we don't have much historical data to go on.

I'll provide a final opinion when we learn the necessary details about IPO terms from management.

Company & Technology

San Francisco-based DocuSign was founded in 2003 to help businesses speed the contract process through the use of online or 'e-signatures.'

Management is headed by CEO Daniel Springer, who has been with the firm since January 2017 and was previously an operating partner at private equity firm Advent International.

DocuSign was founded by Director Thomas Gonser, Jr., who is currently a venture capitalist at TMD Ventures.

Major investors in the firm include Sigma Partners (12.9% pre-IPO), Ignition Partners (11.7%) and Frazier Technology Ventures (7.2%). Notably, CEO Daniel Springer owns no company shares.

DOCU has created an online platform and service for businesses of all sizes and individuals to process contract signatures in a secure manner.

Customer Acquisition

DOCU sells a variety of functional packages via its subscription software-as-a-service [SaaS] business model.

The firm claims to have more than 350,000 businesses as users, with over 650 million 'Successful Transactions' on its platform. Management sees a total addressable market [TAM] of approximately $25 billion.

It sources Fortune 2000 customers through a direct sales and marketing strategy.

VSBs, or Very Small Businesses, can access the system through its online self-serve channel.

DOCU's dollar-based net retention rate for each of the last two fiscal years was 115%, which is a relatively good number.

A n et $ retention rate of greater than 100% means that the firm's topline revenue would still increase even if it didn't add a single customer.

Market

According to a market research report by MarketsandMarkets, the U.S. digital signature market is expected to reach $2.66 billion by 2021.

This represents a CAGR of approximately 32% between 2016 and 2021. This is quite a high growth rate for virtually any category of software or related services.

Research and Markets forecasts CAGR through 2025 to be in ‘double digits’ and driven by a transition away from on-premises systems to cloud-based offerings.

End users such as financial institutions will figure prominently in adoption during the period due to desired reductions in time, effort and costs associated with documentation processing.

Competition

Major and minor competitive vendors that provide digital signature capabilities include:

- Adobe Systems (ADBE)
- Secured Signing
- Gemalto NV (OTCPK:GTOFF)
- Ascertia
- Entrust Datacard Corporation
- SIGNiX
- eSignLive
- RPost
- IdenTrust
- Thales e-Security

Management says that it views Adobe as its primary global competitor and that other vendors only provide solutions to ‘specific industries or geographies.’

Financials

DOCU’s recent financial results can be summarized as follows:

- Strong growth in topline revenue
- Increasing gross profit dollars
- High and increasing gross margin percentage
- Reduced cash used in operations nearing CFFO breakeven

Below are the company’s operational results for the past two years (Audited GAAP):

	Year Ended January 31,	
	2016	2017
	(in thousands, except share and per share data)	
Consolidated Statements of Operations Data:		
Revenue		
Subscription	$ 229,127	$ 348,563
Professional services and other	21,354	32,896
Total revenue	250,481	381,459
Cost of revenue(1)(2)		
Subscription	48,656	73,363
Professional services and other	25,199	29,114
Total cost of revenue	73,855	102,477
Gross profit	176,626	278,982
Operating expenses:		
Sales and marketing(1)(2)	170,006	240,787
Research and development(1)(2)	62,255	89,652
General and administrative(1)(2)	63,669	64,360
Total operating expenses	295,930	394,799
Operating loss	(119,304)	(115,817)
Interest expense	(780)	(611)
Interest income and other income (expense), net	(3,508)	1,372
Loss before income taxes	(123,592)	(115,056)
Provision for (benefit from) income taxes	(1,033)	356
Net loss	$ (122,559)	$ (115,412)

(Source: DocuSign S-1)

Revenue ($)

- FYE 2017: $381.5 million, 52% increase vs. prior
- FYE 2016: $250.5 million

Gross Profit ($)

- FYE 2017: $279 million
- FYE 2016: $176.6 million

Gross Margin (%)

- FYE 2017: 73%
- FYE 2016: 70%

Cash Flow from Operations ($)

- FYE 2017: $4.8 million cash used in operations
- FYE 2016: $68 million cash used in operations

As of January 31, 2017, the company had $190.6 million in cash and $176.9 million in total liabilities less Contract liabilities.

Curiously, the firm has only supplied two years of financial data, which is the minimum required. DocuSign has been in existence since 2003. I would have expected at least three years, but perhaps management didn’t like FYE 2015’s financial results or FYE 2016’s growth comparison to 2015.

IPO Details

DOCU intends to raise $100 million in gross proceeds from an IPO of its common stock, although the final figure may be as high as $400 million.

Notably, the firm is not employing a multiple class share structure.

Management says it will use the net proceeds from the IPO as follows:

The principal purposes of this offering are to increase our financial flexibility, create a public market for our common stock and facilitate our future access to the capital markets.

We also intend to use a portion of the net proceeds from this offering to satisfy tax withholding and remittance obligations when we settle our RSUs granted prior to the date of this prospectus, as well as those granted after the date of this prospectus, which will begin to vest after the completion of this offering with respect to any then-outstanding RSUs subject to a performance-based condition tied to a liquidity event requirement, which will be satisfied on the effective date of this offering.

Management’s presentation of the company roadshow is not currently available.

Listed bookrunners of the IPO are Morgan Stanley, J.P. Morgan, Citigroup, BofA Merrill Lynch, Deutsche Bank Securities, JMP Securities, Piper Jaffray and William Blair.

Commentary

DocuSign has been a bit of a sleeper of a company in the tech world, having been founded in the aftermath of the dot.com bust.

But, the firm has come into its own as businesses have transitioned to the cloud and legal structures have become more comfortable with digitally-signed agreements.

DocuSign has been a pioneer of sorts within the industry and stands to gain considerably in the years ahead as business continue to adopt more efficient contract administration processes.

I’ve long thought that the firm is an ideal acquisition target for the growing cohort of technology quote-to-cash firms, which could add DOCU’s capabilities as part of a suite of end-to-end offerings to businesses.

Perhaps we'll see that occur, or maybe DOCU will decide to acquire a promising upstart to further build out its own capabilities once it has more currency or stock to acquire the pieces with.

In any event, financial performance has been robust, though as previously mentioned, I would like to have seen at least another year of history with which to judge financial metric trends.

Another question mark in DOCU's more-distant future is the effect of blockchain and cryptographic signature technologies on its enterprise business. It isn't a short-term concern, but certainly one to keep in mind for the medium- or long-term.

I expect DOCU's IPO to see significant demand, so valuation will be critical for interested investors to determine whether to join institutions for this offering.

When we receive pricing and valuation numbers from management, I'll provide a final analysis.

Expected IPO Pricing Date: Not on calendar.