PTC Inc. (PTC)
Raw Notes from Virtual NDR

Maintain Outperform. Below we include our raw notes from meetings with PTC.

■ Current Environment

■ Generally speaking, customers have proceeded “as normal” with spending so far. Churn rates have performed in line with the company’s expectations through the April time frame. For Fiscal Q3 (June), a majority of expiring contracts happen in April; even this past month, renewal rates were in line with expectations.

■ While not a large number, certain customers are asking for greater flexibility with payment terms (e.g., instead of the typical annual pay-in-advance, inquiring about installment payments).

■ Apart from renewals, PTC is currently seeing more pressure on net new deals. This is particularly the case on products where “high touch” sales engagement is typically seen at the beginning (e.g., PLM and IoT). On the other hand, existing customers in the “high touch” categories are still showing interest in expansion deals since expanding the number of users is easy to do.

■ Management feels the product portfolio is very relevant to today’s business requirements, which should be of help. Even Creo can be temporarily accessed from home. Windchill PLM is accessed through web browser.

■ Primarily Serve SMB space through the reseller channel. About one-third of ARR is contributed by indirect sales today.

■ By industry vertical, PTC has very low exposure to the oil & gas space and commercial airlines (what exposure exists pertains to spare parts management with the Focused Solutions Group). The company’s A&D exposure, roughly 15% of ARR, is much more skewed to defense programs where US government spending has remained strong.

■ Half of support contracts have transitioned to actual subscription contracts at this point. These are still on-prem products, it is just the contracting model that is different. But part of the rationale for this transition was to enable greater flexibility with respect to upgrades/downgrades/etc than was the case with support contracts. And based on conversations around contracts that have come up for renewal, PTC is seeing customers value this flexibility.

■ Continued on Page 2.

PTC, Inc. offers software products used for CAD modeling, Product Lifecycle Management (PLM), Service Lifecycle Management (SLM), and Internet of Things (IoT).
Details

Fiscal 2020 Outlook

- The original FY20 outlook assumed a modest YoY improvement in churn, while the updated outlook now assumes a degradation in churn. While the company has not yet seen a significant variation from its original plans, management decided to take a “haircut” from YTD experience and internal plans to better account for the possibility of lower retention rates. The low end of guidance – ARR growth of 9% YoY – assumes business developments that are worse than the 2009 experience.

- In the course of doing restructuring for a “SaaS-ier” future entering Fiscal 2020, PTC ended up taking out more costs than anticipated. Now in a fortunate position when addressing impacts from the pandemic. You can see this with respect to updated opex guidance, where instead of expecting 9% YoY growth, now expecting 2% YoY growth.

- Built some level of cushion into FCF forecast. In management’s view, the question is “when” not “if” customers will ask for greater payment flexibility. Have already seen a small handful of customers reach out for payment alterations: if normal contractual arrangement is annual in advance; can we instead pay in 2-3 installments.

Growth Portfolio

- Remote work is proving to be a catalyst for cloud-based CAD and PTC’s recent OnShape acquisition. Level of interest in this solution and the resulting pipeline have grown nicely.

- Part of the gains in “mindshare” for OnShape have come from the education market, where management estimates a 5-10 percentage point improvement in market share during the last two months.

- In regards to IoT/AR, learnings from the COVID-19 business environment could prove to be an eventual catalyst as it reinforces the value proposition of remote monitoring for smart factories and devices. MedTech is already driving a spike in usage as more equipment is deployed into the field. When it comes to the manufacturing sector, net new deals typically require onsite engagement and this area has slowed with many factories shut down. Once back online, PTC is likely very well positioned. One interesting anecdote on lead generation being driven by Augmented Reality: Rockwell drove half of the 10,000+ signups for Vuforia Chalk in the quarter, with PTC seeing “enormous” interest in new use cases.

Competitive Position

- PTC and Autodesk operate in slightly different parts of market. Autodesk commonly found in high volume / lower price segments of the market. PTC often participates in more high end CAD applications.

- In terms of share shifts at high end, the company has not seen this happen all that much.

- At the low end, where new demand is being created, PTC has not participated as much historically (in comparison to an Autodesk or Solidworks). But with the addition of OnShape, PTC now has this opportunity. OnShape is a cutting edge product that is native, multi-tenant SaaS.

- AR is still a nascent market. There is still no real commercial competition with IoT and AR. Competition is from companies trying to roll their own solution.

Partnerships

- The more challenging end to the March quarter impacted all of the PTC partnership efforts to some degree. In regards to ANSYS, this included fewer net new seats being sold. Now going forward, the new version of Creo – Creo 7.0 – has a whole new set of technology from ANSYS built into it (e.g., CFD and updates to Simulation Live). Adding that capability is going to help drive demand.
The next big push for Creo Simulation Live is in the indirect channel. So far, direct sales have been more successful.

The Rockwell partnership is going well, current environment aside. Rockwell noted it is signing new deals on top of competitor equipment, which is an important development. PTC feels the partnership is well past the initial fits/starts; ultimately the learning curve took a bit longer than expected, but now the partnership is in a good place.

Rockwell drove half of the 10,000+ signups around Vuforia Chalk in the most recent quarter. Enormous interest in this use case, and Rockwell leaned in heavily.

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**Investment Thesis**

**Valuation.** Our $88 price target is based on 23x our NTM FCF estimates, one year from now. This is consistent with the median valuation of the trailing twelve months, a level that we believe weighs current market uncertainties against the company’s strong growth opportunity. Over the past three years, PTC has traded between 20x FCF and 45x FCF. As the company executes on its subscription business model and drives double-digit ARR growth with higher FCF, we believe there is likely upside to valuation.

**Benefiting from the convergence of physical and digital worlds.** Gartner estimates that the number of IoT endpoints will grow by over 30% per year through 2020. PTC’s existing relationships with device manufacturers who are CAD/PLM/SLM customers puts PTC in a unique position to drive a significant acceleration in growth as their nascent IoT business continues to gain traction.

**Business model transition.** PTC is in the process of transitioning its user base from Perpetual License and Maintenance to Subscription. We believe that while the transition creates a short-term deceleration in revenue growth and margins, the long-term effect will be higher steady-state earnings power and cash flow generation as the model normalizes.

**Improving go-to market.** PTC brought on a new COO in 2015 and improved the way PTC goes to market, driving increased accountability and direct management of the salesforce while working to better leverage the indirect channel (which is especially important for IoT). While the COO has since moved on to take a CEO position back in Europe, the discipline and cadence he brought to the sales organization still persists.

**Financial metrics have hit their trough.** Headline metrics like top-line revenue growth, margins, and free cash flow will continue to improve as we advance through the transition. As these headline metrics steadily improve under a steady-state business model, investors should see outperformance even as valuation multiples compress to normalized levels.

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**Risks & Caveats**

**Growth tied to success of nascent IoT business.** The IoT space is in the early stages of development with a number of competitors vying for share in what stands to be a very large market in the future. If PTC is unable to continue to drive innovation in its IoT business, future growth may lag management’s goal of low-teens growth.

**Competition.** PTC faces competition in its core CAD/PLM/SLM markets from a number of well-established companies, such as Autodesk, Dassault, and Siemens. Attrition in the core business due to increased competition could significantly reduce future growth and valuation.
Execution risk. PTC is in the early stages of its business model transition, and execution missteps could result in increased customer attrition and depressed growth and margins.

Company Description

PTC, Inc. offers software products used for CAD modeling, Product Lifecycle Management (PLM), and Service Lifecycle Management (SLM). Additionally, PTC offers a suite of Internet of Things (IoT) solutions that enable its customers to connect “smart” devices, analyze associated data, and create IoT applications. PTC is organized into two business units: 1) Solutions (includes CAD, PLM, and SLM products) and 2) IoT. PTC is headquartered in Needham, MA and has over 5,800 total employees.
**Appendix - Important Disclosures and Analyst Certification**

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**Rating and Price Target History for: PTC Inc. (PTC) as of 05-08-2020**

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