SolarWinds Corporation (SWI)

Baird Facts

Price ($) (5/27/20): 18.16
52WK H-L ($) : 22 - 12
Market Cap (mil): 5,680
Shares Out (mil): 312.8
Float (mil): 52.8
Avg. Daily Vol (mil): 0.91
Dividend ($): 0.00
Yield (%): 0.0

Rating: Outperform
Suitability: Higher Risk
Price Target ($) : 20
L-Term Rev. Gr Rate Est: 10%
L-Term EPS Gr Rate Est: 15%
Debt/Cap: 76.4%
ROE: 37.2%

Outperfrom FY Dec 2019A 2020E 2021E
Q1 0.20A 0.20A 0.23E
Q2 0.20A 0.21E 0.24E
Q3 0.21A 0.22E 0.25E
Q4 0.24A 0.24E 0.27E
Total 0.85A 0.87E 0.99E

FY P/E 21.4x 20.9x 18.3x

Headquartered IPO/Founded

Management

Kevin B. Thompson President & CEO
Bart Kalu CFO
Howard Ma Sr Director IR & FP&A

Company Description
SolarWinds, headquartered in Austin, TX, is a leading provider of IT infrastructure management software. Its products give organizations worldwide, regardless of type, size or IT infrastructure complexity, the power to monitor and manage the performance of their IT environments, whether on-premises, in the cloud, or in hybrid models. Its product suite includes network management, systems management, cloud, and managed systems providers (MSP). The company has over 325,000 customers, including small and medium-sized businesses (SMBs), enterprises (including the entire Fortune 500), and government entities.

Revenue Profile

Source: Company Reports and Robert W. Baird & Co. estimates

Quick Summary
- SolarWinds reported better-than-expected 1Q20 results which offered revenue and adjusted EBITDA at or above the high end of guided ranges. Subscription revenue (38% of total) was a particular highlight coming in +34% yr-yr in CC which was nicely above plan for +29-32%. Subscription should continue to benefit moving through 2020 and beyond given the newly introduced subscription pricing offerings for core products (which were offered only as license/maintenance until last week). SMB churn is a modest risk, but we continue to recommend SWI at current levels.
- SolarWinds reported 1Q20 revenue/EPS of $248.4M/$0.20 versus consensus of $241M/$0.20 and our estimate $243M/$0.21. These results compared to management guidance for revenue $243.5-248.5M and EPS $0.20-0.21. Revenue was +15% yr-yr as reported and +16% in CC. We estimate organic CC revenue (assuming ~$7.0M inorganic) of +13% yr-yr.

Revenue by segment:
- License $37.0M (-2.6% yr-yr, -2.0% CC) vs consensus $37.1M (-2.2% yr-yr).
- Maintenance $116.3M (+10.0% CC) vs consensus $114.3M (+8% yr-yr)
- Subscription of $95.1M (+33.0% yr-yr, +34.3% CC) versus consensus $91.5M (+28% yr-yr) and management guidance $91.5-93.5M. Assuming $7.0M of inorganic contribution translates to +23% yr-yr in organic CC. Strength driven by improved

Company Competition
SolarWinds faces competition from a panoply of software vendors, many of whom have a product footprint and sales-driven presence in the IT department. The company offers strong products that differentiate on low friction and price. However, an inability to keep up with the evolving needs to their customers could drive customers toward competitors.
SolarWinds Corporation
May 27, 2020

MSP performance (majority of the subscription revenue today), solid infrastructure monitoring and APM, and contributions from ITSM (Samanage acquisition). Recurring revenue (Subscription + Maintenance) was 85% of total revenue and grew +19% yr-yr (+20% CC).

- **Adjusted EBITDA** of $110.9M compared to guidance of $108-112M and consensus of $112M. Adjusted EBITDA margin this quarter was 44.6%.
- **Other highlights included:** 1) Customers >$100k ended at 926, up 22% yr-yr; 2) Maintenance renewal rate 92% in 1Q20 was negatively impacted by a planned downgrade of a large US Federal renewal; 3) Net-dollar retention rate 106% overall (and 108% for MSP business);

**Liquidity.** SolarWinds has $237M of cash and EBITDA to cash flow conversion rate is expected to improve throughout the next three quarters (cash balance expected to grow). Net leverage of 3.7x TTM adjusted EBITDA (down from 3.9x in December). Debt ($1.9B as of March 31) does not begin to mature until 2024.

**Withdrawing 2020 guidance** due to uncertainty around COVID impact. Additionally, SolarWinds may see some moving parts to top-line level revenue from newly introduced subscription offerings. If more customers adopt subscription offerings will represent an upfront headwind (not expected to be material in 2020, but hard to forecast adoption rates at this point).

2Q20E guidance:

- Revenue $240-248M (+4-8% yr-yr, +6-9% CC) versus consensus/Baird $247M/ $250M. No individual line item guidance was provided this quarter.
- Adjusted EBITDA $108-112M versus consensus $117M. Implies EBITDA margin ~45%. EPS $0.20-0.21 versus consensus/ Baird $0.21/$0.21.
- Maintenance renewal rate expected to be low-90’s and subscription net retention 101-103%.

**Investment Thesis**

**Valuation.** We arrive at our $20 price target by applying a 23x P/E or 29x EV/EPS multiple (EV to take into account net debt) to our 2020E EPS estimate. Our 23x forward P/E multiple compares to a comparable group average of 22x. SWI's unique business model and financial profile combination of double-digit growth and above-average profitability (targeting 45%+ EBITDA margins) make for an attractive asset that we believe warrants this target multiple. In summary, we view SWI as a compelling investment, with public and private investor interests aligned (another positive to the overall investment thesis).

**Power business model.** SolarWinds' unique go-to-market drives significant value. The company does not possess a traditional enterprise salesforce, rather it sells its products directly over the Internet. This enables the company to deliver exceptional value for customers, with low costs and easy implementations (no professional services, little to no customization). This also results in best-in-class operating margins. The company generates leads though digital marketing initiatives and by mining its own user community. Additionally channel partners are affiliated with approximately 50% of sales.

**IT growth/products.** SolarWinds is in the "sweet spot" serving IT departments that have become much more strategic to global businesses. SolarWinds' disruptive "fast follower" mentality, combined with their low touch business model, creates substantial value for IT buyers. Increasing complexity in IT departments is driving a greater need for visibility across networks, systems and applications. SWI's product offerings are well positioned to address this growth opportunity.

**The future is lower touch.** Rather than representing an anomaly, we believe companies such as Atlassian and SolarWinds -- companies powered by a low-cost, direct model that serves the rapidly evolving innovation needs of their customers -- represent in part the future of software sales. Given the market they serve, the products they sell and the price points they offer, we see no risk SolarWinds would ever hire an enterprise sales force. Additionally, the emergence of the SMB sector as a consumer of IT solutions is spurring the growth of Managed Service Providers (MSPs). There are currently 100k MSPs but that number is expected to rise as consultants and channel partners evolve their businesses to meet the complex outsourced IT needs of this market. SolarWinds' MSP solutions are geared to this market and they are very well positioned to benefit from this trend.

**Veteran leadership.** SolarWinds was a public company from 2009 to 2016, when it was taken private by a private equity group led by Silver Lake Management. CEO Kevin Thompson has been with SolarWinds for 15 years and remains at the helm; Bart Kalsu, CFO and the rest of the team represent a deep bench of management talent that we expect to be disciplined defenders of their powerful business model.

**Risks & Caveats**

**Competition.** SolarWinds faces competition from a panoply of software vendors, many of whom have a product footprint and sales-driven presence in the IT department. The company offers strong products that differentiate on low friction and price. However, an inability to keep up with the evolving needs to their customers could drive customers toward competitors.

**Quarterly variance.** While SolarWinds' revenue model is now >80% recurring, the company has less ability to manage its pipeline the way a traditional software company can, and thus can be prone to quarterly variance.

**Digital marketing.** While SolarWinds direct, low-friction sales model is a powerful driver of our investment thesis, the company's sales will depend in part on the ability to market digitally to the changing needs of their IT customers. If the company fails to reach customers successfully through digital marketing initiatives, sales could be negatively impacted.
Leverage. The company has substantial debt on the balance sheet from the take-private in February 2016, and net leverage of ~4X at the end of 2019. Management has stated they plan to de-lever, and their power model and free cash flow generation support that. However, if the company were to fail to see traction with new products, or made larger acquisitions, the leverage ratio could rise.

Supplemental Information
We arrive at our $20 price target by applying a 23x P/E or 29x EV/EPS multiple (EV to take into account net debt) to our 2020E EPS estimate.
2 Robert W. Baird & Co. Incorporated and/or its affiliates managed or co-managed a public offering of securities of SolarWinds Corporation in the past 12 months.

3 Robert W. Baird & Co. Incorporated and/or its affiliates have received investment banking compensation from SolarWinds Corporation in the past 12 months.

1 Robert W. Baird & Co. Incorporated makes a market in the securities of SWI.

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