Vocera Communications, Inc. (VCRA)

Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

<table>
<thead>
<tr>
<th>Price ($) (5/12/20):</th>
<th>18.69</th>
</tr>
</thead>
<tbody>
<tr>
<td>52WK H-L ($) :</td>
<td>35 - 16</td>
</tr>
<tr>
<td>Market Cap (mil):</td>
<td>592</td>
</tr>
<tr>
<td>Shares Outs (mil):</td>
<td>31.7</td>
</tr>
<tr>
<td>Float (mil):</td>
<td>31.0</td>
</tr>
<tr>
<td>Avg. Daily Vol (mil):</td>
<td>0.53</td>
</tr>
<tr>
<td>Dividend ($) :</td>
<td>0.00</td>
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<tr>
<td>Yield (%):</td>
<td>0.0</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Rating:</th>
<th>Outperform</th>
<th>FY Dec</th>
<th>2019A</th>
<th>2020E</th>
<th>2021E</th>
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<tbody>
<tr>
<td>Suitability:</td>
<td>Higher Risk</td>
<td>Q1</td>
<td>(0.17)A</td>
<td>(0.14)A</td>
<td>(0.16)E</td>
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<tr>
<td>Price Target ($) :</td>
<td>30</td>
<td>Q2</td>
<td>0.07A</td>
<td>(0.31)E</td>
<td>(0.03)E</td>
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<tr>
<td>L-Term Rev. Gr Rate Est:</td>
<td>10%</td>
<td>Q3</td>
<td>0.23A</td>
<td>0.12E</td>
<td>0.19E</td>
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<tr>
<td>L-Term EPS Gr Rate Est:</td>
<td>15%</td>
<td>Q4</td>
<td>0.15A</td>
<td>0.20E</td>
<td>0.23E</td>
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<tr>
<td>Debt/Cap:</td>
<td>42.9%</td>
<td>Total</td>
<td>0.29A</td>
<td>(0.13)E</td>
<td>0.23E</td>
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<td>ROE:</td>
<td>15.0%</td>
<td>FY P/E</td>
<td>64.4x</td>
<td>NM</td>
<td>81.3x</td>
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</table>

Company Description

Vocera Communications (VCRA) is the leading provider of next-generation clinical communication and workflow solutions for hospitals and health systems. VCRA currently supports 1,400 facilities worldwide (including 270 non-healthcare facilities), to deliver secure, integrated communications solutions to clinicians at the point of care. VCRA’s communications platform includes hand-free voice communication, secure text messaging, and patient engagement tools, which can be integrated into existing clinical systems. VCRA was founded in 2000, and is headquartered in San Jose, CA.

Revenue Profile

- **Product revenue (51% of revenue)**. Product revenue is comprised of both Device and Software revenues. Device revenues primarily consist of sales of the Vocera-branded badge, as well as accessories such as batteries, chargers, and lanyards. Additionally, Device revenue includes the resale of Zebra MC40s devices, but we believe this is a smaller portion of Device revenue vs. Vocera-branded badges. Software revenue is primarily tied to the Vocera Communication System and Engage software platform, which is typically sold on a licensed software basis. Product segment gross margins are in the 70% range. We believe Device gross margins are ~65% and Software gross margins are ~85%.
- **Services revenue (49% of revenue)**. Service revenue includes Maintenance and Support and Professional Services revenue. Maintenance and Support revenue is billed to VCRA clients annually and provides ongoing support, bug fixes, and software upgrades. Professional services revenue is largely tied to new client installations and training. Services segment gross margins are in the 50% range. We presume Professional Services gross margins are in the ~15% range (similar to peer companies), implying Maintenance and Support gross margins are in the 60-70% range.

Figure 1: VCRA Business Profile

Source: Baird, company reports
Competition

Competition. While we believe VCRA is the leader for next-generation communication solutions, the company directly competes against several well-capitalized companies, such as Cisco (wireless phones) and Hill-Rom (Voalte). Additionally, while EHR vendors like Epic and CERN do not currently provide solutions that directly compete with VCRA, it is possible these larger companies could take a more active approach.

Quick Summary

- **1Q20 Recap:** Surprisingly strong. Revenues of $40.6M (+15% YoY) came in well ahead of Street estimates at $37.5M and more recent expectations near $34M. EBITDA of negative $2M was higher than consensus at $3.7M and guidance negative $2.5M-$5.0M. Relative to our model, the revenue upside was entirely driven by Devices, reflecting urgent COVID-related orders. Other revenue lines (Software, Maintenance, Prof Services) were in-line. Gross margins were slightly above our model (60.9% vs. our 60%) and the EBITDA upside was driven by higher revenues.
- **Bookings softer, offset by urgent orders.** Backlog+deferred revenue increased 5% YoY, which was relatively encouraging (similar to normal growth trends). According to management, new bookings were below target and some implementations were pushed out due to COVID. However, this was partially offset by a higher number of urgent Device orders related to COVID. VCRA badges are helping hospitals expand isolation capacity, preserve PPE, and improve safety. Key bookings in the quarter included: (1) $1.2M urgent order from Kaiser, (2) $1.1M Army hospital, and (3) international wins in Kuwait, UAE, and the UK.
- **No guidance but not surprising.** VCRA withdrew guidance and did not provide an outlook for 2Q. We are not surprised by this and expect most of our coverage will withdraw guidance. According to management, revenue and profitability will be lower than originally expected, but VCRA did not quantify. This suggests the lower bookings and implementation delays will outweigh the benefit from urgent Device orders.
- **Sustainability of urgent orders.** According to management, the uptick in urgent orders continued into April. Initially, urgent orders were associated with COVID preparation, as hospitals looked for ways to expand capacity. More recently, VCRA believes demand is being driven by safety concerns and we view this as a more sustainable driver. While many regions have not seen a spike in COVID, hospitals will need to ease patient anxiety in order to ramp elective/scheduled surgeries.
- **Other highlights:** (1) VCRA issued several thousand complementary licenses to customers. Management hopes some will convert to revenue in the future. (2) Several late-stage pipeline deals paused when COVID hit; VCRA is optimistic these deals, along with broader strategic opportunities, will be completed at some point in the future. (3) VCRA continues to improve its remote implementation capabilities.
- **Model update, lowering price target to $30.**

Investment Thesis

Our call: We are Outperform-rated. VCRA is a fundamentally different company than just a few years ago. Today, VCRA’s communication solutions are integrated into clinical workflows, which enhance depth/importance with customers and differentiation vs. competitors. Additionally, after several years of EHR-heavy investments, hospital IT spending is now focused on key themes benefiting VCRA (i.e., EHR workflow, patient safety, etc.), which we believe will sustain strong organic growth for multiple years. Finally, after a period of elongation (during 2019), we now believe VCRA’s sales cycle has stabilized, which increases our confidence in future growth.

Valuation and price target. Our $30 price target is based on a 4x EV/Revenue multiple applied to our 2021 estimate, which is in line with the company’s three-year average of ~4.5x.

Risks & Caveats

Our suitability rating for VCRA is Higher Risk. Our suitability rating is based on VCRA’s leading position for next-generation communication solutions, above-average growth profile, and low leverage, squared against relatively low margins/FCF, dependence on suppliers, and niche focus. Key risks to our estimates and price target include:

- **Competition.** While we believe VCRA is the leader for next-generation communication solutions, the company directly competes against several well-capitalized companies, such as Cisco (wireless phones). Additionally, while EHR vendors like Epic and CERN do not currently provide solutions that directly compete with VCRA, it is possible these larger companies could take a more active approach.
- **Device revenue and investor perceptions.** ~40% of VCRA revenue comes from device sales. While VCRA makes very attractive gross margins on its devices (~60%), some investors may perceive the higher device/hardware mix as a negative for VCRA, given lower device margins with other IT companies. In our view, this perception issue could negatively impact VCRA’s valuation.
- **Information security.** VCRA’s solution involves the collection, storage, and analysis, of sensitive client and patient information. Loss or theft of sensitive information could have an adverse impact on VCRA’s ability to compete and grow. Additionally, VCRA is subject to various state and federal regulations related to data security, primarily including HIPAA and HITECH.
- **M&A-related risks.** VCRA organic growth has been supplemented by several acquisitions over the last several years, including Extension Healthcare (2016), mVisum (2014), and Prana Technologies (2014). The inability to successfully integrate these acquisitions (or future acquisitions) could have an adverse impact on our estimates.
- **Other.** Other risks include VCRA dependence on a number of sole-source and limited-source suppliers for hardware (i.e., batteries and integrated circuits), as well as challenges impacting the hospital end market, such as low margins and political/policy uncertainty.
Appendix - Important Disclosures and Analyst Certification

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

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