Model N, Inc. (MODN)
Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

Price ($) (5/19/20): 27.77
52WK H-L ($) : 36 - 15
Market Cap (mil): 919
Shares Out (mil): 33.1
Float (mil): 26.3
Avg. Daily Vol (mil): 0.39
Dividend ($) : 0.00
Yield (%): 0.0
Rating: Outperform
Suitability: Higher Risk
Price Target ($) : 33
L-Term Rev. Gr Rate Est: 12%
L-Term EPS Gr Rate Est: 25%
Debt/Cap: 44.4%
ROE: 20.0%
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Debt/Cap: 44.4%
ROE: 20.0%
Outperform 2019A 2020E 2021E
FY Sep Q1 0.03A 0.12A 0.09E
Q2 0.01A 0.07A 0.06E
Q3 0.06A 0.07E 0.10E
Q4 0.12A 0.05E 0.11E
Total 0.23A 0.31E 0.35E
FY P/E NM 89.6x 79.3x
EPS (Cal) 0.32A 0.29E 0.37E
P/E (Cal) 86.8x 95.8x 75.1x

Headquartered IPO/Founded
San Mateo, CA 2013/1999
Management
Chief Executive Officer Jason Blessing
Chief Financial Officer David Barter
Investor Relations Reuben Gallegos, Gwyn Lauber

Company Description
Model N, Inc., headquartered in San Mateo, California, provides revenue management solutions to the global life sciences and technology industries. Revenue management takes what has historically been a disjointed and manual set of processes – pricing, contracting, incentives, rebates, channel management, regulatory compliance – and instead creates a connected end-to-end strategy. The company offers two cloud-based platforms that specifically address unique vertical industry requirements, helping customers maximize revenues and reduce costs by enabling greater visibility, accuracy, regulatory compliance, automation, and responsiveness. The company was founded in 1999 and completed its initial public offering of common stock in 2013.

Revenue Profile

Source: Baird estimates, Factset, Company reports

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Model N, Inc.
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Competition
Model N faces competition from several different areas including spreadsheet-assisted manual processes, internally developed solutions, multi-industry ("horizontal") revenue management solutions that do not focus specifically on life sciences or technology, and several point solutions offered by smaller companies.

Quick Summary
- Reiterate Outperform rating. Strong F2Q results included revenue growth of 15% YoY (beating by 4-5%), accelerating new subscriptions, and improving financial returns with EBITDA/FCF both up nearly 80% YoY. Industry exposure of Pharma + High Tech not immune to COVID-19 impacts, but overall there appears to be good resiliency which is supporting a better-than-expected outlook for remainder of FY20 (with 96% visibility on F3Q/F4Q). From a strategic standpoint, we believe the company’s products are rising in importance for customers which should keep the pipeline of future engagements healthy.
- F2Q (March) demonstrated strong performance with revenues of $40.0 million (+15% YoY) beating expectations by 4-5% and EBITDA of $3.2 million (+76% YoY) above expectations closer to $2.0 million.
- Business highlights: a new logo win with flu vaccine developer Seqirus, opting for a partner-led delivery of Revenue Cloud that leverages Model N’s templatized approach for quick time-to-value; the completed global rollout of deal management and channel management for electronic component supplier AVX; a “big” go-live with Novartis that took place 100% virtually; and the transition of the generics division of Mallinckrodt to Revenue Cloud in a record six months (compared to the first on-premise transition with Gilead at 18 months).
- Calculated billings (revenue + change in deferred) had another strong quarter, rising nearly 40% YoY. This growth was achieved amidst a more challenging environment toward the end of the quarter: management noted one new logo deal slipped during F2Q and that two customers asked if invoicing could be delayed until F4Q (impacting deferred revenues by $3mm or 8%).
- F20 (September) guidance narrowed toward high end of prior ranges, a better-than-expected outcome. Forecasts reflect a high degree of visibility coming off several strong quarters for billings and discussions with key prospects regarding Professional Services activity (seeing little disruption).
- F3Q revenues are seen $39.4-39.8 million (+14% YoY), 5% above consensus expectations. EBITDA of $3.6 million (+8% YoY) is above expectations closer to $3.0 million.
- F4Q revenues are seen $154-156 million (+10% YoY), 1% above consensus expectations. This implies a deceleration in YoY growth during F4Q, but also reflects what is largely “in hand” today and likely takes a conservative approach to new deal activity for upcoming quarters. EBITDA of $14-15 million (+11% YoY) is above expectations closer to $13-14 million.
- Rising strategic importance for revenue management continues to be evident in new business activity for Model N. The new logo win with Seqirus this quarter is a good testimonial to this point: in the midst of spiking demand for influenza vaccines, Seqirus came to the conclusion that internal systems were not equipped to support the demand environment and therefore turned to revenue management to run the business better.

Investment Thesis
Model N cloud transition comes at opportune time. Following an eventful Fiscal 2018 that included the appointment of a new CEO, improvements in Model N’s go-to-market effort, introduction of measures to ease a customer’s migration to the cloud (e.g., ramped deal terms where subscription cost matches the customer’s usage over time), and optimized implementation (e.g., templatized approach, greater automation to shorten test cycles), subscription revenue growth has accelerated and affirms the early motion by customers to adopt revenue management in the cloud.

Land + expand strategy drives next stage of growth. There are multiple ways for Model N to grow subscription revenues and further penetration of the $4.0 billion addressable market for cloud-based revenue management.
- Landing new logos remains an important driver and starting point given the company sells to fewer than 10% of the addressable logos in its core verticals.
- Within the existing customer base, momentum is firmly in place for remaining on-premise license customers to undertake the move toward cloud-based revenue management.
- The most meaningful ARR opportunity comes from expanding the number of cloud solutions per customer over time. Even within the largest Pharma customers, the company estimates its solutions are less than 30% penetrated relative to the full dollar potential from selling the entire product suite across all business units/users/geographies at these key accounts.

High tech benefiting from greater channel visibility. For Model N customers in the semiconductor and electronic component industries, it is typical for 70-90% of sales to go through an indirect channel and yet the company estimates 75-80% of such companies are not using a dedicated solution to improve channel visibility. Based on a recent company presentation, the number of high-tech companies making investments in this area is up 5x during the last 18-24 months.

Executing well against margin expansion, cash flow strategy. Adjusted EBITDA margin expanded 200bp in Fiscal 2019, and we expect will track toward management’s outlined goals of 15-20% by Fiscal 2022 (we model profitability near 15%). Profitability is benefiting from 20% growth in recurring software revenue and associated uplift for software gross margin. Targeted investments in sales and product development during Fiscal 2020 are expected to result in a near-term pause in expense leverage, with renewed progress toward targets expected in upcoming years.
Valuation. Our $33 price target is based on an EV/Sales multiple of 6.0x applied to our NTM sales estimate, one year from now. This is equal to the median valuation of the 12 month trading range (high/low of 8.0x/4.0x over this timeframe). We believe the median valuation is appropriate as the company continues to execute on its cloud transition opportunity, weighed against risks related to the COVID-19 environment.

Risks. Key risks include the following: 1) variability in quarterly financial performance driven by timing associated with on-premise transitions, new cloud bookings, and project implementation schedules; 2) lengthening in sales cycles as larger enterprise customers consider strategic deployment of revenue management; 3) end-market considerations for customers in the life sciences and technology industries, including demand cycles, IT budgeting, and potential disruptions from M&A activity; 4) potential disruptions of cloud services to customers; 5) competition; 6) customer concentration; 7) the ability to generate cash to fund existing debt obligations; and 8) the uncertainties created by COVID-19 and potential impacts on customer spending decisions.

Risks & Caveats

Variability in quarterly financial performance. Quarterly performance can be influenced by timing of new cloud bookings and migrating legacy on-premise customers to cloud solutions. In Fiscal 2020, management noted one-time costs associated with migrating the final 20 customers off of older cloud environments.

Lengthening in sales cycles. Model N has been effective in employing standard approaches to implementation which have simplified delivery of revenue management solutions and reduced launch timelines. Implementation can range from a few months for an individual solution, to up to 12 months for a broader system rollout; recent implementations with customers pursuing an on-premise transition have taken place in the 10-12 month range. Revenue management is complex and sales to enterprise customers can require greater time to evaluate, test, and adopt Model N solutions. Model N, in prior years, has noted delays in customer IT budget decisions as having an impact on financial results.

End-market considerations. Factors that negatively impact customers in the life sciences and technology industries could have an impact on Model N. Customers in the life sciences industry have numerous factors to consider when weighing investments, including the emergence of large purchasing organizations and integration healthcare networks, increased customer and channel incentives and rebates, the shift of purchasing influence between physicians and buyers, increased spending on healthcare by different entities, regulatory reporting and audits, and fines/penalties.

Potential disruptions of service. Revenue management is a critical function to organizations and an interruption in service could negatively impact customers with ramifications for Model N in the future. Model N currently provides cloud-based solutions through third-party data centers and depends on internet access from third-party bandwidth providers. Information security is also of extreme importance and data breaches could negatively impact customers and jeopardize Model N's reputation.

Competition. Model N faces competition from several different areas including spreadsheet-assisted manual processes, internally developed solutions, multi-industry ("horizontal") revenue management solutions that do not focus specifically on life sciences or technology, and several point solutions offered by smaller companies.

Customer concentration. During Fiscal 2019, the 15 largest customers accounted for 49% of total revenues. Concentration with large customers has declined during recent years as Model N Solutions have been adopted by a wider audience. For example, Johnson & Johnson was the largest customer in Fiscal 2018 at 15% of total revenue but was no longer responsible for generating above 10% of revenue in Fiscal 2019. For subscription revenues, no customer represented more than 10% of revenues.

Ability to generate cash to fund existing obligations. Free cash generation has improved from an outflow of $13 million during Fiscal 2017 to positive $10 million during Fiscal 2019. We expect continued improvement in cash generation as Model N executes on its cloud subscription strategy, with free cash flow used to pay down existing debt. Total debt outstanding declined by 18% during Fiscal 2019 to $44 million.

Seasonal characteristics of financial and stock performance. There is a certain amount of seasonality to Model N financial performance due to discrete operating expenses, with EBITDA lower in the first half of the fiscal year due to new marketing programs and the company’s annual user conference. Additionally, some of Model N’s larger customers prefer to release new technology projects during the calendar fourth quarter, which may have the potential to skew revenue recognition until later in the calendar year.

Supplemental Information

Our $33 price target is based on an EV/Sales multiple of 6.0x applied to our NTM sales estimate, one year from now.
Appendix - Important Disclosures and Analyst Certification

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Rating and Price Target History for: Model N, Inc. (MODN) as of 05-19-2020

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

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

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