NETSUITE

Long Idea: 2012 Price Target = $46
2020 Price Target = $220

Last Update: 9/12/11

Market Cap / Price: $1.98bn / $29.50
52 Week Low / High: $19.24 / $42.81
Beta / Yield: 1.24 / 0%
Geo%: 79% US, 21% International

Guidance:
2011 Revenue: $228mn to $230mn versus the Street at $234mn
2011 Adjusted EBITDA: $0.13 to $0.15 versus the Street at $0.14

Liquidity:
>$17mn daily

Valuation

2011 P/E: N=202x vs S&P= approx 13x
2012 P/E: N=91x vs S&P= approx 13x

2011 EPS Growth: N= 8% vs S&P= 5%
2012 EPS Growth: N= 123% vs S&P= 3%

Bottom Line: I am typically more valuation sensitive, but I make some exceptions when I see that the market opportunity is incredible. As such, valuing NetSuite should incorporate the significant long term market opportunity when compared to SAP and Salesforce.com. Competitor SAP has a market cap of about $60bn and focuses largely on the traditional client server based ERP market. Competitor Salesforce.com focuses largely on CRM, which is a subset of ERP. Since NetSuite in the long run will compete in the same markets as SAP and Salesforce, there is a strong argument to be made that the market cap of NetSuite can one day conservatively be as large as Salesforce. As such, this would imply close to **800% upside over the next 10 years to a target price of $220**. This is not a stretch given the market opportunity. NetSuite could easily have much higher margins today if they stopped investing in growth (margins will only be 4.7% this year). I believe that the company will be competitive with very large scale enterprise wide ERP deployments in the long run via the systems integration channel (i.e., Accenture); currently, they are focusing more on the mid level market. If we *conservatively* assume that revenue can grow approximately 25% annually through 2020, then this implies a target price in 2020 of $220 (implies 24x 2020 EPS or 3x using today's share price – which is conservative as I am assuming earnings could grow by 40% in 2020 ~ please see the model below). If we conservatively discount the $220 target price by about 20% annually, then we get to a 2012 target price of $46. After 2012, I expect 20-25% annual share price appreciation thereafter. At this long term target price, the market cap would be about $15bn, which is achievable. I used to work at Accenture and we put Siebel on the map, which was only a CRM module. Accenture just signed a contract with NetSuite, which has a much more comprehensive and forward looking business model than Siebel ever did given NetSuite's embrace of the cloud and all ERP modules.

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Assumptions
Revenue	$ 193	$ 239	$ 299	$ 373	$ 467	$ 583	$ 729	$ 912	$ 1,140	$ 1,425	$ 1,781	*Enterprise market penetration to lead to accelerated or at least*
Revenue Growth	*16%*	*24%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*	*sustainable revenue growth.*
Operating Margin	5.4%	4.7%	8.3%	13.3%	18.3%	23.3%	28.3%	33.3%	38.3%	43.3%	48.3%	*Management decided to invest in*
EPS	$0.13	$0.15	$ 0.33	$ 0.52	$ 0.90	$ 1.44	$ 2.20	$ 3.24	$ 4.66	$ 6.59	$ 9.20	*growth early on. Expect 500bps*
EPS Growth	*160%*	*8%*	*123%*	*59%*	*74%*	*60%*	*52%*	*47%*	*44%*	*41%*	*40%*	*annual margin expansion in 2013+.*
P/E	219x	202x	91x	57x	33x	20x	13x	9x	6x	4x	3x	$220 target in 2012 = 24x P/E

Fundamentals

Drivers/Catalysts:
- Cloud Based Computing Secular Growth: We are still in the early innings of the cloud based computing paradigm shift. Investors underestimate the significance of this shift; this transition is more disruptive than the transition from mainframe to client server.
- IT Services Sector Adoption: Accenture recently signed a distribution and implementation agreement with NetSuite; expect more IT Services announcements. More IT Services adoption will help NetSuite move upstream and penetrate the enterprise market and cannibalize share from SAP.
- Lower Total Cost of Ownership: Client server ERP installations are much more costly given high costs of hardware, installation, personnel and maintenance.
- Seamless Upgrades: Since the software is hosted on NetSuite's servers, the upgrades are quite simple to perform.

Competition:
- Higher end: SAP, ORCL | Lower end: CRM, MSFT, INTU

Risks:
- Near Term: Valuation – derisking, data privacy/security, and spending deferrals given anemic global economy (CFO told me that business has not slowed down since August).
- Long Term: Enterprise market penetration execution and competition from larger vendors.

Financials:
- Q2 Recap: Focused on top line growth (not margin expansion yet). Revenue growth was 22%. EPS growth was 165%. 2.7% operating margin. Raised Guidance.

Balance Sheet: $121mn cash. 0 debt.

Management:
- CEO: Zach Nelson – since 2002. Less promotional than Marc Benioff but a respected cloud based pioneer and Oracle veteran. Ellison is a fan hence his investment.
- CFO: Ron Gill – since 2010. Seems conservative. Previously SVP of Finance at NetSuite.

Bottom Line: NetSuite (ticker: N) has the opportunity to capture material enterprise market share from SAP in the long run; we are only in the early innings of the cloud computing paradigm shift and NetSuite is in the sweet spot in the cloud ERP based market. Currently NetSuite is more focused on the mid market, but IT Services companies are starting to embrace NetSuite, which is a precursor for meaningful enterprise deployments in the long run, which the street is not expecting. I spoke with the CTO of Accenture and NetSuite is extremely well positioned from a strategic client deployment perspective in the long run.