

Veeva Systems Inc Class A VEEV |

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Veeva's Wide Moat in Life Sciences Cloud Services Remains Strong Despite Increased Competition



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Analyst Note 02/27/2019

Veeva reported strong results exceeding our expectations driven by robust cross-selling of incremental modules into its existing customer base, and guidance was raised accordingly. We maintain our wide moat rating on the niche enterprise cloud-based provider. For perspective, shares are trading at 58 times 2019 free cash flow.

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For the fiscal fourth quarter, revenue grew 25% year over year to \$232.3 million, while normalized EPS grew 104% year over year to \$0.45. Subscription revenue increased 25% year over year, while services revenue increased 22%. Deferred revenue increased 33% and came in higher than the quarterly revenue growth during that same period. Billings of \$394 million were \$21 million ahead of guidance driven by strong bookings, billing duration, and strong services revenue. Taken together, deferred revenue and billings trends continue to suggest that the underlying business remains robust. Normalized operating margin of 36% increased from 30% year over year as management scales the business.

Management provided revenue guidance for the first quarter of \$238 million to \$239 million, above our expectations and consensus of \$233 million, with EPS guidance of \$0.44-\$0.45 compared with consensus of \$0.40. Fiscal 2020 revenue guidance was also increased to \$1.25 billion to \$1.30 billion, up from \$1.10 billion with EPS guidance of \$1.91-\$1.94. The company continues to benefit from better penetration into existing customers and shortened client implementations, and trends are likely to continue throughout 2019.

Business Strategy and Outlook 11/29/2018

Veeva Systems was the first mover in providing customer relationship management services specifically designed for pharmaceutical companies, and we believe its niche position, top-tier software, and operation-critical services will allow it to enjoy long-term economic profits on par with a wide-moat firm. Veeva's minimal client churn, substantial market share, and growing appeal outside the life sciences space bolster our view of the firm as a market leader.

Veeva currently has two main categories of business: Veeva Commercial Cloud, its vertically integrated CRM products, and Veeva Vault, its horizontally integrated content and data manager. The Commercial Cloud products can manage all forms of interaction between a biotech company and its customers. This product portfolio is built through a partnership with Salesforce on the Salesforce1 platform. We estimate Veeva has increased its biotech CRM market share to at least 70%. Furthermore, by operating in the life sciences vertical, Veeva has developed software specifically tailored to these firms, thereby reducing its customer acquisition costs and increasing cross-sales, with over two thirds of revenue growth in fiscal 2018 coming from existing customers. We expect Veeva Nitro, a newly announced cloud-based data warehouse offering dependent on the Veeva CRM platform, to strengthen this segment with AI-driven data analytics capabilities.

Morningstar's Take VEEV

Analyst		
Price 03-01-2019	Fair Value Estimate	Uncertainty
118.22 USD	92 USD	Medium
Consider Buy	Consider Sell	Economic Moat
64.4 USD	124.2 USD	Wide

Stewardship Rating

Standard

Bulls Say

- There is the potential for strong growth in underserved international markets.
- As more CRM customers begin to use Vault and Network, switching costs will continue to increase and entrench the existing customer base.
- Veeva Vault and Network appeal to customers in highly regulated industries outside the life sciences market, providing significant expansion opportunities.

Bears Say

- Entrenched software providers, such as Microsoft and Oracle, could develop an offering that targets life sciences customers and competes directly with Veeva.
- To expand Vault's client base outside the life sciences space, customer acquisition expenses may increase.
- Increased consolidation in the healthcare space could ultimately limit total subscriptions sold.

Competitors VEEV

More...

Name	Price	% Chg	TTM Sales \$ mil
Veeva Systems Inc Class A	\$118.22	0.25	811
Cerner Corp	\$55.98	0.04	5,366
Covetrus Inc	\$36.01	0.39	3,799
Medidata Solutions Inc	\$75.00	0.03	611
Teladoc Health Inc	\$65.38	1.58	418
HealthEquity Inc	\$81.84	1.66	272

The Vault platform offers a unified, customizable cloud product and benefits from substantial switching costs. This has been a boon to Veeva, as increased need for regulation and quality control, especially in healthcare, warrant more sophisticated content management solutions. We believe Vault has the potential to attract additional customers outside life sciences, such as chemicals and consumer packaged goods, and drive solid growth over the next few years.

We expect Veeva's level of innovation, capacity to identify underserved industries, entrenched position, and ability to increase its total addressable market through new product launches to endure.

Economic Moat 11/29/2018

We believe Veeva has a wide economic moat formed by intangible assets and high customer switching costs. Veeva began as a customer relationship management company with a focus on the life sciences industry but has since established two pillars of its core business: Veeva Commercial Cloud and Veeva Vault. These two businesses, each with a growing suite of specific products, have been adopted by over 600 customers, including the majority of large-cap pharmaceutical and biotech companies.

Veeva operates in a niche market by exclusively focusing on the life sciences space and, as a first mover, faces little competition. Veeva began by replacing outdated CRM products and benefited from the regulatory intangible assets associated with the life sciences niche. Veeva's products are typically government-mandated necessities, which precludes the business from a scenario where negative headwinds could reduce the discretionary spending of the company's life sciences customer base. Currently, Veeva's development of vertical-specific software has let the firm accumulate a large body of knowledge about the specific regulatory issues and compliance needs of its users. Veeva has utilized knowledge of the industry to develop and sell complementary products to existing customers, growing value per contract while keeping customer acquisition costs manageable. Furthermore, other CRM offerings tend to be on premise solutions that require more complicated and time-consuming installations, whereas Veeva's cloud-based platform can go live in a shorter period of time and quickly scale as the number of users within an organization grows. Veeva has won contracts with large pharmaceutical firms, which we view as evidence that its offerings must have above-average functionality, instead of just appealing to price sensitive customers.

Veeva Commercial Cloud, the foundation of which is the company's CRM application, is vertically integrated and provides a collection of products designed to help life sciences firms market their products more effectively. Estimates suggest Veeva controls 65% of the life sciences CRM space, compared with estimates of IQVIA's 15% market share. The infrastructure of Veeva's CRM products is built utilizing salesforce.com's Salesforce 1 Platform. The current agreement between the firms, which extends to 2025, is mutually beneficial for both parties. Veeva leverages salesforce.com's infrastructure to sidestep development costs and can compete in the life sciences space without competition. In tandem, salesforce.com is guaranteed a certain amount of Veeva's revenue and Veeva is precluded from selling its CRM products outside of the pharmaceutical and biotechnology industries. However, Veeva Systems has successfully expanded Veeva Vault, its suite of joint content and data applications, with appeal outside the life sciences industry. In fiscal 2017, Vault grew from 219 to 334 customers while commercial cloud grew from 212 to 259 customers. Ultimately, the intangible assets as a result of Veeva's agreement with Salesforce.com and the immense regulatory data necessary to hold appeal in the life sciences space strengthens Veeva's moat.

Veeva's initial CRM products allowed drug companies to streamline their salesforce. As a firm's salesforce becomes accustomed to using Veeva's software, switching costs rise, especially given the centrality of the platform to a firm's sales and marketing efforts. As Veeva has built out its suite of products, its pharma and biotech clients have continued to integrate Veeva's offerings. We forecast an increased ability to cross-sell to existing customers as Veeva continues to add products to its enterprise platform. Veeva Vault, the company's content and data manager, can accomplish a plethora of tasks from storing call center scripts, housing process documents in a manufacturing setting, and tracking regulatory submissions for a new drug. Pharmaceutical clients utilizing Veeva CRM have adopted Vault to manage clinical

drug trials and ensure stringent adherence to regulatory guidelines. Thus, the increased adoption of complementary Veeva products, some of which house critical drug data, creates even stickier customer relationships. Clients will likely seek to avoid migrating sensitive data to a competitor's platform, unless subscription fees become exorbitantly expensive. Veeva's customer revenue retention rate was 121% in fiscal 2018, which is calculated by combining customer churn with cross-sales or upsells, and the number has always been above 100%. This further demonstrates Veeva's entrenchment in client operations and ability to charge increasing or premium prices for its offerings. Lastly, the horizontally integrated platform appeals to highly regulated industries beyond life sciences, which includes the chemicals, manufacturing, and consumer packaged goods industries. Vault provides quality management, which allows the company to house highly sensitive information, such as a document that demonstrates how a machine needs to be cleaned and Vault can track who opened that document, who emailed that document, and who made changes to that document. We believe that Vault's management of sensitive data creates switching costs outside the life sciences industry.

Veeva's current business model seeks to increase the firm's switching costs. Veeva introduces its newer products to a set of early adopters, ranging in size from small biotechs to large pharmaceutical clients, before rolling these products out to its entire customer base. This allows the firm to test the functionality of new products, preventing customer dissatisfaction or other issues that could lead to delays in implementation or customer churn. Moreover, early adopters receive slight discounts on subscriptions, which may serve as an incentive to attract clients outside of Veeva's established customer base before the switching costs associated with its software take hold.

Fair Value and Profit Drivers 11/29/2018

We are maintaining our fair value estimate of \$92 per share. Veeva's services segment has driven outperformance in fiscal 2019 as there is greater demand for implementation services as new products are adopted. We model over 27% growth in the services segment for fiscal 2019, but we expect growth to slow over our explicit forecast as new products mature and scale. We anticipate double-digit growth in the subscription and services segments through 2023. Our confidence in top-line growth is in part due to the potential for the recently announced Veeva Nitro product, a cloud-based data warehouse offering dependent on the Veeva CRM platform. We believe Nitro will strengthen the platform's sales, marketing, and analytics capabilities and help it compete with rival CRM providers like Oracle and IQVIA, especially given IQVIA's entrenched advantage in data analytics. We continue to believe that Veeva's newer products, such as Vault eTMF (electronic trial master file) and Vault CTMS (clinical trial management), will grow as Veeva adds clients, which bolsters the services segment as well. Our valuation assumes a compound annual revenue growth rate of nearly 19% through 2023 thanks to double-digit growth in both subscription and services. This assumes \$1.6 billion in sales by 2023. Our estimates factor in share gains, as Veeva attracts customers from legacy platforms, and increasing revenue per customer with successful cross-selling. We model gross margins improving slightly to 71.7% by 2023, largely due to the migration to Amazon Web Services. Our midcycle operating margin of 28.5% is driven by a smaller portion of revenue going toward research and development as software development costs can be spread over a larger revenue base.

Risk and Uncertainty 11/29/2018

Veeva faces medium uncertainty, in our opinion. Veeva's revenue retention rate has remained close to 100% for the last several years, with minimal churn among its existing customers. Due to the high switching costs associated with Veeva's products, we expect the company to maintain leading market share in the industry.

Veeva's products typically help clients with critical operating tasks, some of which are government mandated. Therefore, if cyclical headwinds affected the discretionary spending of Veeva's base, we would not expect high customer churn among the firm's existing clients.

Still, because a majority of the firm's revenue comes from a set number of large pharmaceutical firms, the loss of even one contract could have a material impact on

the overall business. In fiscal 2018, nearly 42% of the company's revenue came from Veeva's top 10 customers, down from 45% the prior year. Furthermore, there is uncertainty surrounding the ease at which Vault and Network can scale and expand to various customer bases. Veeva Vault has begun expanding outside of the life sciences industry and it remains to be seen whether this initiative will be a sustainable driver of growth. As Veeva enters markets where customers need quality control, such as the chemicals and consumer packaged goods industries, it remains to be seen whether it can continue expanding into other businesses. Additionally, Veeva could face tougher competition from IQVIA or other entrenched software players, like Oracle and Microsoft, which have enough capital to strengthen their existing CRM and content management applications or acquire a smaller competitor.

Stewardship 11/29/2018

We assign Veeva a Standard stewardship rating and think that the company's actions have been shareholder-friendly. CEO and cofounder Peter Gassner has had a long tenure in the software industry, including experience at IBM, PeopleSoft, and Salesforce. Cofounder and president Matt Wallach had experience at Siebel (acquired by Oracle), a legacy CRM player, as well as several other healthcare technology companies. We believe Gassner's experience at Salesforce strengthens the partnership between Veeva and Salesforce, bolstering our confidence that their mutual agreement will run past 2025.

We believe that Veeva's capital allocation strategy has been prudent over the last several years. The acquisition of Zinc Ahead and Qforma CrowdLink in fiscal 2016 expanded Veeva's presence in the commercial content management and key opinion leader data spaces and should make Vault both more valuable to current customers and attractive to a wider audience. Furthermore, management's acquisition strategy has been disciplined, as the company did not need to take on debt to fund these two acquisitions. We expect this trend to continue. Management has continued to invest in key areas such as product development, head count, and expanding to clients outside life sciences while keeping selling and marketing costs at fairly stable levels. The fact that the company has remained profitable while growing at a rapid pace bolsters our belief that management has done a fine job balancing innovation with profitability and will continue to allocate capital wisely as the firm's products mature.

Overview

Profile:

Veeva Systems provides cloud-based software to customers in the life sciences industry for customer relationship, content, and data management. Veeva CRM is a suite of applications that help pharmaceutical and biotechnology companies market and sell products to healthcare providers. Veeva Vault, a product built on proprietary software, is a cloud-based application built to manage content and associated data. The company is also expanding its client base to sectors outside life sciences, including chemicals and industrials.

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