

Qualys Inc.

Strong profitability metrics with an exciting secular growth trend

Company Description

Qualys is a cloud-based provider of security solutions. Its main business focus is vulnerability management. The company's primary product: Qualys Cloud Apps is an umbrella term for its suite of solutions.

Investment Thesis

The company has strong profitability metrics and high margins over its peers. These represent a durable competitive advantage as Qualys products continue to be the default choice for cloud solutions. Its operating efficiency can be attributed to strong management. For two decades, its current CEO has used his experience to guide the company's success.

Catalysts

The trend of transitioning to the cloud is being strengthened by the current COVID-19 pandemic. As more employees work remotely, companies will increasingly seek cloud-based solutions. With new products being released in 2020, the company remains innovative.

Investment Risks

Shorter contract lists are responsible for the recent fall in its stock price. Analysts will not be happy if customers continue to seek more flexibility in payment.

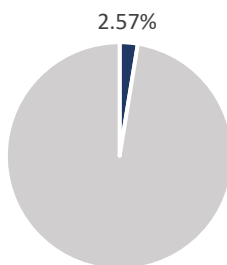
Valuation

Using a DCF model, an intrinsic value of \$115.02 was derived. This represents a 26.2% upside from current levels.

Market Share

Qualys Revenue
\$321.6M

Vulnerability Management
Industry
\$12,500M



Recommendation	BUY
Current Price	\$91.11
Target Price	\$115.02
Upside	26.2%
Risk	MEDIUM

Key Data

52W range	\$63.37 – 125.22
Mkt Cap (mm)	\$3,833
EV (mm)	\$3,485
Shares Outstanding (mm)	39.25

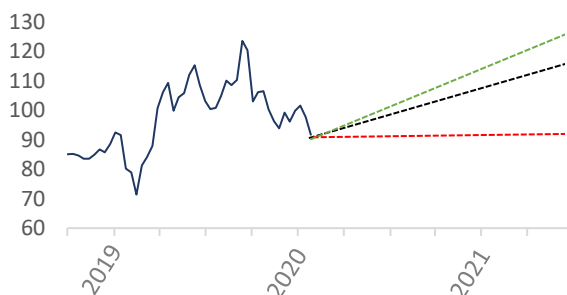
DCF Valuation: Perpetuity

Intrinsic Value	\$	98.86
Discount / (Premium)		7.7%
Upside		8.5%
Discount Rate		7.8%
Perpetual Growth Rate		1.6%
Implied Exit Multiple		12.5x

DCF Valuation: Exit Multiple

Intrinsic Value	\$	114.32
Discount / (Premium)		43.5%
Upside		25.5%
Discount Rate		7.8%
Exit Multiple		23.4x
Implied Perpetual Growth Rate		4.7%

Price Performance



Source: Yahoo Finance Data

Company Overview

Founded in 1999, near the tail end of the dot-com bubble, Qualys is a cyber security company offering a suite of cloud-based products. Headquartered in Foster City, California, the company has over 15,700 customers spanning across 130 countries. An innovative group, Qualys was the first to offer security solutions in the form of Software-as-a-Service (SaaS)¹. Phillipe Courtot, angel investor and security expert, seeded Qualys and helped raise \$65 million in 2001. He soon became the company’s CEO where he remains today².

Figure 1: Revenue Breakdown

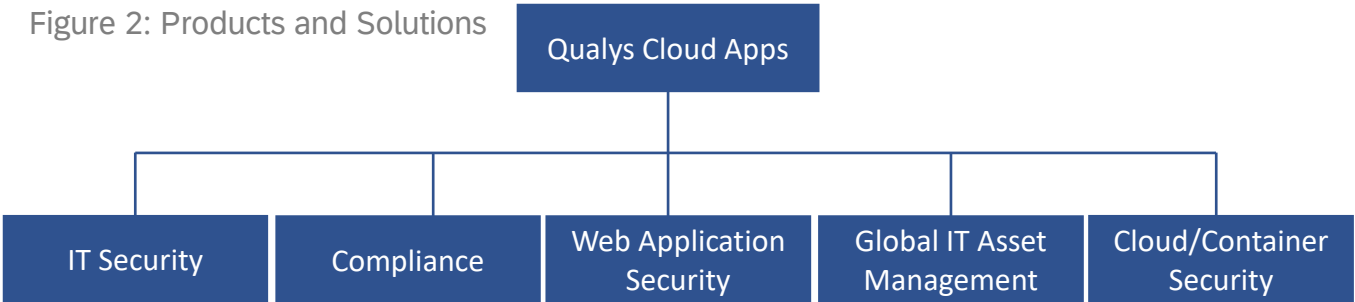


Source: Qualys 10k

Qualys is a cloud-based provider of information technology and security solutions. The Qualys platform protects customers from cyber attacks through the Qualys Cloud platform. Organizations are increasing their presence globally, intensifying the need to maintain an easy and secure flow of information. As organizations seek to lower IT costs and improve efficiency, they are transitioning over to the cloud and thus the lines between internal and external systems are becoming blurred³. These trends represent a fundamental shift in the way in which business is conducted as there will be great efficiencies and cost savings realized. With these new opportunities, however, new vulnerabilities are created. Qualys is well positioned to take advantage of these trends, as it offers a cost effective and scalable security cloud platform.

Business model. They have several free products, using the ‘try and buy’ strategy, allowing companies to get acquainted with their products to convert them into paying customers⁴. Its flagship product; *QualysGuard* is the most deployed security solution in the world, conducting more than 6 billion maps and scans per year⁵. Its current suite: *Qualys Cloud Apps* is an umbrella term for multiple solution categories (see Figure 2). Revenue is segmented based on two categories; direct and partner. The partner segment makes up 42% of revenues and utilizes third parties to help distribute and raise awareness of Qualys products. With direct making up 58% of revenues, it is further split into the *enterprise segment* (more than 5000 employees) and the *mid market* (fewer than 5000 employees). 73% of their revenues generated fall under the category of vulnerability management (VM) making it their most important segment.

Figure 2: Products and Solutions



Source: Annual report

Industry Overview

One of the largest corporate security breaches in U.S. history was the hacking of Equifax in 2017. The personal information of 147 million Americans being stolen was a nightmare no enterprise wants to face⁶.

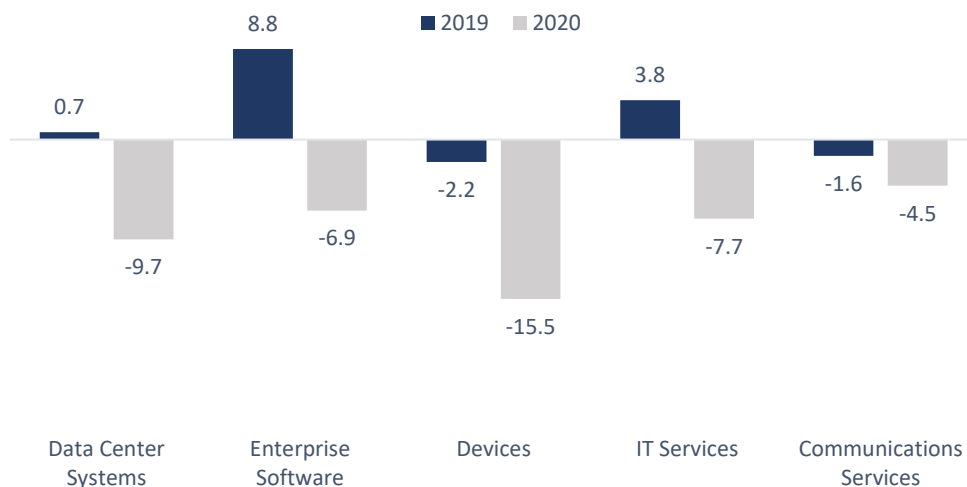
68% OF BUSINESS LEADERS SAID THEIR CYBERSECURITY RISKS ARE INCREASING

Accenture^{7,8}

AVERAGE COST OF CYBERCRIME FOR AN ORGANIZATION INCREASED \$1.4M TO \$13.0M

Vulnerability Management (VM) is currently a \$12.5B market and is expected to grow to \$15.5B by 2025. This represents a 4.5% CAGR⁹. The industry is highly fragmented with a few large players and many small ones. As a response to this, many companies are partnering with each other in order to grow market share. Qualys partnered with Microsoft to integrate its platform on Microsoft Azure. Other partnerships include Vodafone with IBM, and Aureimma with Donato¹⁰. Based on these statistics, business leaders foresee an increase in attacks while the cost per attack increases. Corporate spending in IT security will therefore continue to grow. The COVID-19 pandemic has exasperated the situation as a large portion of the workforce has migrated to the home office. Remote access to privileged IT admin functions are a particular vulnerable target. As a rise in phishing attacks has been observed, 79% of businesses have reported to be increasing security procedures for remote access¹¹. As a result of the pandemic and ensuing recession, IT spending is predicted to decline by 8% in 2020. This is a broad category however, upon closer inspection different segments within IT will see different results. Hardware sales will be the hardest hit as the transition to the cloud is expected to accelerate¹². A study by Deloitte found financial services companies spend on average 10% of their IT budget on cybersecurity. This represents 0.2% to 0.9% of total revenues.

Figure 3: Worldwide Growth in IT Spending



Source:Gartner¹³

Investment Thesis

Industry leading metrics help Qualys stand out from its peers. The company has the highest EBITDA margins out of all its peers at a staggering 35% (see Figure 6). They are also part of the elite ‘rule of 40’ club. The rule of 40 is a metric used to evaluate the growth and profitability of a software company. Being able to post profitability and growth rates whose sum is greater than 40 for a consistent period is a good sign of a sustainable competitive advantage¹⁴. Qualys has been able to do exactly that, demonstrating consistent leadership in the industry (see Figure 5). Figure 6 lists the peers and competitors of Qualys while comparing certain industry metrics. Sales and EBITDA growth for the following year are also expected to be higher than the industry average. We can see Qualys’ ROA, ROE, and ROIC are significantly higher than that of its peers. EBITDA and free cash flow margins are substantially higher than its peers. Based on these metrics, it is clear Qualys maintains a competitive advantage in the industry. Is this advantage temporary or long term? Looking at Figure 5, we can see Qualys has consistently maintained high profit margins over the past five years. Thus we can say this competitive advantage is indeed durable.

Figure 4: EV/EBITDA 5 years

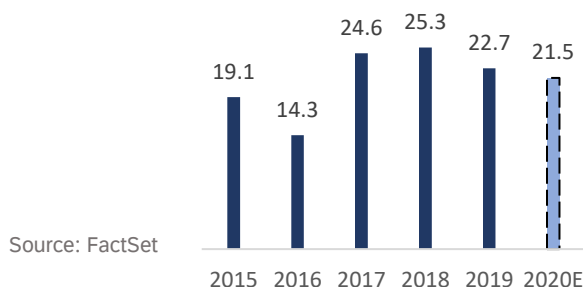


Figure 5: Qualys Rule of 40

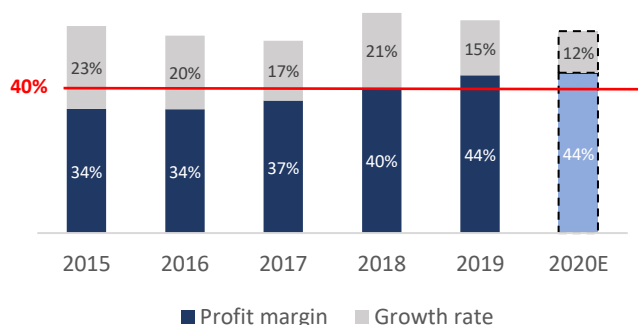


Figure 6: Industry Metric Comparison

Company	EBITDA Margin	ROA	ROE	ROIC	FCF Margin	Sales 1yr Growth	EBITDA 1yr Growth	FCF 1yr Growth	Current Ratio	CAPEX to Revenue
Qualys	35.0	12.5	21.4	19.5	39.7	14.1	30.6	17.4	1.9	7%
Average	12.0	(3.2)	(23.3)	(5.1)	18.0	10.2	4.3	27.3	2.2	6%
Median	12.1	(5.7)	(22.2)	(8.7)	15.5	12.2	4.8	20.8	1.8	5%
Belden	14.7	(7.9)	(24.6)	(10.3)	6.9	(18.8)	(28.7)	(38.5)	2.2	5%
F5 Networks	22.3	8.4	17.2	14.4	28.4	5.0	(18.6)	2.4	1.3	3%
FireEye	(6.5)	(8.9)	(35.2)	(14.6)	1.5	6.8	40.3	39.1	1.7	4%
Rapid7	(10.5)	(9.8)	(82.1)	(16.7)	(3.5)	29.9	(25.8)	54.5	1.5	6%
Palo Alto Networks	9.6	(3.4)	(19.9)	(7.1)	24.1	17.5	28.1	(10.8)	1.9	6%
InterDigital	42.3	2.5	4.9	3.4	50.8	20.6	30.6	117.0	4.5	10%

Source: FactSet

Experienced leadership has guided the company’s success. Angel investor Philippe Courtot is the current Chairman and CEO of the company. Having been an early investor in the company, Philippe was instrumental in securing early financing for Qualys. He has decade of experience in the field, having served in leadership roles of Signio, VeriSign, and cc:Mail¹⁵.

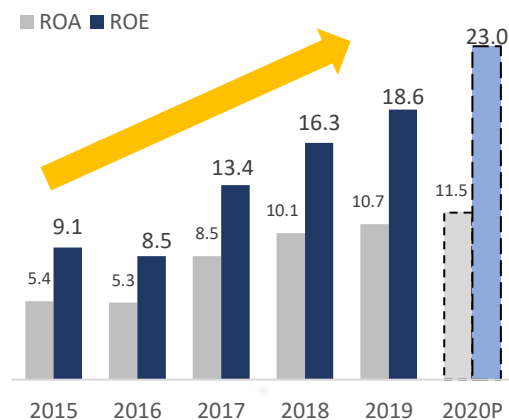
Catalysts

COVID-19 is predicted to accelerate the migration to the cloud. The transition to the cloud has transformed the workplace over the past decade. The trend will continue as the cloud computing market is expected to grow at a 17.5% CAGR by 2025¹⁶. This trend, however, will soon be accelerated as companies migrate their workforce to remote locations as a result of the pandemic. It is estimated that 52% of employees now work remotely¹⁷. This short-term crisis will benefit Qualys as it's customers will look to it to provide more flexible solutions and security.

Improving ratios due to the multiplier effect. The company is attracting more large sized companies. Since 2017, the number of large customers have grown 120%. This had a positive effect on margins as can be seen in the financial ratios (see Figure 6) and the generation of cash flow (see Figure 7). Larger customers will have more resources to engage in multi-product adoption. Multi-product adoption is important, as can be seen in Figure 7, as customers with five (or more) products spend five times as much as two-product customers and have a higher retention ratio. 66% of the Forbes Global 50 have standardized their systems to the Qualys ecosystem. If Qualys can continue attracting large customers, it will see further margin improvement.

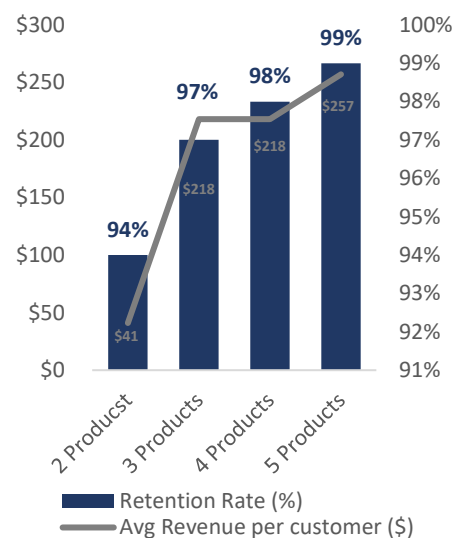
New products will help maintain strong organic revenue growth. The company released a new app in July; the Multi-Vector EDR. The app gives more information and context on potential cyber attack which enables the user to respond faster and with a more automated approach thus reducing costs. In January, the company launched *Qualys VDMR* which identifies vulnerabilities and provides a one-click remediation making the process thorough and efficient¹⁸. Along with these two releases, the company plans on releasing seven new apps later in the year which will further improve the Qualys ecosystem. Maintaining an innovative platform will be essential if they want to continue growing free cash flows (see Figure 8). This can be used for further product development and acquiring new companies.

Figure 6: ROA & ROE (%)



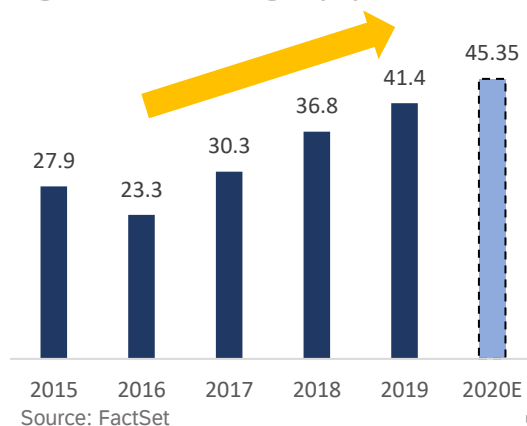
Source: FactSet

Figure 7: Retention Rate & Revenue



Source: Investor Presentation

Figure 8: FCF Margin (%)

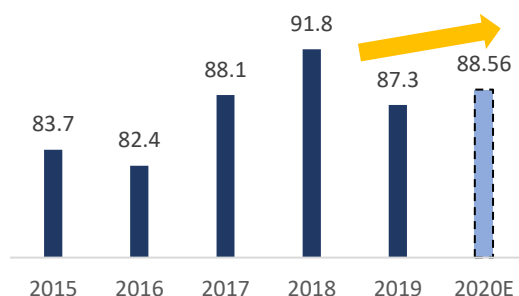


Source: FactSet

Risks

Analyst concerns over shortening contract lists during pandemic. In Q2 of 2020, the company saw a degradation in current billings as well as durations for invoicing. This was attributed to market conditions, as some of its customers may be disproportionality affected. It is to be expected that clients will seek more flexibility in these uncertain times. Naturally, analysts voiced concerns as this is a serious issue if the problem persists past the pandemic. Looking at Figure 9, we can see small increase in days sales outstanding over the past five years. This metric tells us how long, on average, it takes customers make a payment. The company has managed to decrease the figure since its high in 2018, those gains will be erased as the number will likely be higher in 2020¹⁹.

Figure 9: Days Sales Outstanding

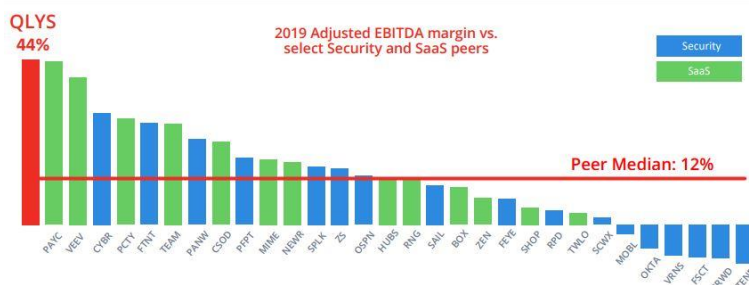


Source: FactSet

Loss of public confidence due to system failure. Revenues are generating from customer renewals. The company currently maintains a renewal rate of close to 100%. If a significant breach occurred, either at the company or for one of its customers, this could damage their trusted reputation and affect renewal rates. In general, large security breeches can have a tangible effect on revenues. A study found that 67% of firms interviewed suffered a cyber security incident which damaged their reputation and 23% reported revenues falling by 7% or more. It stands to reason, if Qualys suffered a security incident, the decline in its reputation would have severe consequences on revenues²⁰.

Overcrowded industry could lead to reduced margins. Qualys operates in a fragmented and competitive industry. The company itself identified over twenty direct competitors such as; Broadcom, CrowdStrike, Belden etc. Some of these competitors have more resources, larger customer bases, and greater brand name recognition²¹. If these competitors were to utilize these competitive advantages or if new players were to enter the space, we could see an increase in competition resulting in lower margins.

Figure 10: Industry EBITDA margin



Source: Investor Presentation

Valuation

DCF: Perpetuity			DCF: Exit Multiple		
Intrinsic Value	\$	99.30	Intrinsic Value	\$	115.02
Discount / (Premium)		7.7%	Discount / (Premium)		43.5%
Upside		8.5%	Upside		25.5%
Discount Rate		7.8%	Discount Rate		7.8%
Perpetual Growth Rate		1.6%	Perpetual Growth Rate		1.6%
Implied Exit Multiple		12.5x	Implied Perpetual Growth Rate		4.7%
Weighted Average Price (75/25): \$ 115.02					

The discounted cash flow valuation yields a final intrinsic value of \$115.02. This was derived using both the perpetuity and exit multiple values. The final weighted average was 75% to the implied perpetuity value and 25% the exit multiple value. These weights were chosen since the exit multiple price was relatively aggressive. Revenue growth and EBIT margin are used as value drivers in the DCF. Revenue growth for the base case was forecasted to be 11.6% in the fiscal years 2020 and 2021, keeping growth flat as a result of the COVID-19 pandemic. After 2021 growth is expected to rise to 17% which is inline with its five-year historical CAGR. EBIT margin for the base case is expected to grow from its current figure of 22% of revenues to 24% by 2025. This is assuming they will continue to improve operating efficiency as they have done historically.

The exit multiple was calculated using a table of comparable peers. Using industry peers we produced an EV/EBITDA of 24.3X as an industry average. This is a conservative figure considering Qualys is currently trading at a 27.6 multiple.

Company	Sales	Market Cap	EV	EBITDA	EV/EBITDA	EV/EBIT	LT Debt / EBITDA	P / FCF	CAPEX
Qualys	342.4	3,598.1	3,304.6	105.9	27.6	37.3	0.4	27.6	(25.0)
Average				207.0	24.3	17.1	(1.5)	58.6	(79.2)
Median				224.1	12.0	17.9	1.9	12.5	(51.7)
Belden	2,058.3	1,407.2	2,654.1	349.3	8.8	14.3	5.2	9.9	(101.0)
F5 Networks	2,326.4	8,210.7	7,902.3	569.0	15.2	19.0	1.4	12.5	(68.4)
FireEye	915.6	3,185.5	3,293.0	(96.5)	-	-	(16.9)	234.6	(34.9)
Rapid7	368.1	3,259.3	3,401.3	(28.2)	-	-	(11.6)	-	(21.6)
Palo Alto Networks	3,408.4	21,455.5	21,183.5	325.8	65.0	-	10.5	26.4	(214.4)
InterDigital	355.4	1,729.8	1,265.0	122.4	8.4	17.9	2.4	9.7	(34.9)

Source: FactSet

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