Industry Bulletin From The Starr Conspiracy Intelligence Unit

The Globoforce IPO: Is there a cloud bubble about to burst?

Is the market's interest in enterprise software and HR technology waning? Are investors getting skittish about cloud companies? Or is there a dangerous misunderstanding of business, billing, and growth models?

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FORT WORTH, Texas (April 2, 2014) — In the enterprise technology industry, the most noteworthy IPO of the year so far is one that didn't happen — Globoforce. As a category leader in rewards and recognition, its IPO was anticipated to be a landmark moment — the first major publicly traded company in the category. However, when the company abruptly postponed its IPO on March 20 citing unfavorable market conditions, many people in enterprise technology circles were confused.

How could market conditions be more favorable than right now? We're seeing the best IPO market in 15 years, and enterprise technology companies that focus on HR and HCM — such as Workday and Cornerstone OnDemand — have been among the market's hottest IPOs recently for a reason. These are fast-growth companies that address a significant market need. Demand for integrated, cloud-based HR and HCM solutions is growing rapidly as businesses see the benefits and value these technologies create — reducing risk and cost, increasing efficiency and agility, and making it easier to attract, retain, develop, and engage talent. Depending on whose numbers you cite, the total addressable market for HR/HCM technologies is $14 billion to $24 billion. However, IDC expects the market size for recognition solutions alone to reach $32 billion by 2016. And TSCIU actually believes the total addressable market is much higher for both.

To see how explosive the possibilities are within the HR technology industry, look at another recent IPO: Castlight Health, an enterprise cloud company focused on healthcare pricing transparency. It saw its stock price surge from $16 a share to nearly $40 — giving a company that posted $13 million in revenue last year a market cap of more than $3 billion. As a result, the Castlight Health IPO had some market watchers dropping the "bubble" word.

Now, fast-forward one week: Globoforce withdraws its IPO and one director of a venture capital research firm said in *The Boston Globe* that the news is evidence that the markets haven't gone haywire. "Investors are still looking at financials, still evaluating company by company."

So, what's going on? Irrational exuberance? A canary in the coal mine for a cloud tech bubble burst? Or did the market suddenly get religion on investment fundamentals?

At The Starr Conspiracy Intelligence Unit, we believe that market conditions have changed. We see lots of confusion in the market about how enterprise software companies in the cloud grow and that some analysts don't get it. **For a company to grow market share and win its category, it has to overinvest in sales and marketing.** We fear this issue could become larger than Globoforce and have an impact on solid companies that have innovative approaches and technology that address real business problems that need solutions. Case in point: Even Workday — which has seen 440 percent revenue growth over the past two years — has seen its stock take a beating since mid-February (down 17 percent). Cornerstone OnDemand's stock is down almost 25 percent over the same period.

We don't believe there is a bubble, and we don't believe that HR technology companies are operating in defiance of good corporate governance. They are operating within the established market dynamics of enterprise software. You'll see this line in a lot of SEC filings for cloud software companies: *"We have a history of cumulative losses, and we do not expect to be profitable for the foreseeable future."* Just because you see that line in an S-1 — and you will for every SaaS-based company — it doesn't necessarily mean "no clue how to be profitable." Most of the time it means "we want to grow and win this category because the payoff is worth it." Unfortunately, this lack of understanding could create negative ripples for launching IPOs, raising capital, and closing deals. We believe that this issue is bigger than the Globoforce IPO and the recognition category. This is about the growth prospects for the entire HR technology category. We believe it's important to explain what's going on at all levels, and we hope that this analysis will bring some clarity and sanity to the discourse.

What happened with the Globoforce IPO?
Back in November, Globoforce said in an SEC filing that it set pricing for its IPO at $75 million. On March 17, the company's SEC filing said that it was trying to raise $79 million (4.4 million shares at $16 to $18 a share). On March 20, the company announced in an SEC filing that it scaled back its offering plan to $57 million, with fewer shares offered (3.8 million) at a lower price range ($14 to $15 a share). Then, late in the evening of March 20, it announced that it was deferring its IPO. A newspaper article has since indicated that the company is now looking at an end-of-year time frame for an IPO.

We believe that on one level, what happened with Globoforce is simple: It's difficult to understand Globoforce's business model, and investors don't invest in companies they don't understand. Globoforce declined to comment for this analysis, but we did talk to many executives, investors, and thought leaders in the category about the IPO and HR technology. Based on these conversations and our own analysis, we believe there are three primary reasons for the postponement:

- The billing model for rewards and recognition companies in general is difficult to understand and can easily cause confusion.
- Globoforce's S-1 filing reflects too much risk — it's operating at a loss and has too much revenue tied up in a handful of clients — and could be clearer in a few areas.
- Globoforce positions itself as a technology company but looks more like a traditional rewards company.

"I'm sorry this happened because I really believe a successful IPO would have been good for the entire rewards and recognition category," said Pete Chambers, chairman and CEO of Inspirus, a leading rewards and recognition provider. While we agree with this assessment, we're more concerned that the resulting confusion could have a negative impact on market opportunities for companies in this category, as well as other HR technology companies. We fear a backlash due in part to the fact that there is a lack of understanding about a fundamental market reality in enterprise software.

The two growth models in enterprise software

The business reality of enterprise software in the cloud is that fast-growth tech companies funded by VC, PE, or IPO money will operate at a loss while they grab market share — even Workday and Cornerstone OnDemand.

In any enterprise software category, there are two types of companies: profit companies and market share companies. **Profit companies** focus on a business model that is familiar to most — they are in business to make money and must see black ink on the books every month. Typically, a profit-driven company will spend about 5 to 10 percent of gross revenue on sales and marketing, but can go higher if the company wants faster growth. Typical year-over-year growth for these companies is 10 to 33 percent.

Market share companies operate in a fundamentally different way. They spend disproportionately on sales and marketing in an attempt to capture market share to increase valuations ahead of an IPO or an acquisition. It's not uncommon to spend 25 to 35 percent or much more on sales and marketing for market share companies because they aim for 40 to 100 percent year-over-year growth. There are three steps to this model:

- **Step 1: Secure private funding.** Overspend on sales and marketing.
- **Step 2: Go public.** Expand market share and platform capability with multiple acquisitions. Overspend on sales and marketing.
- **Step 3: Get acquired.** Shift to profit strategy. Pull back on sales and marketing.

A good example of the market share strategy in enterprise technology played out in the integrated talent management category:

- SuccessFactors won the category when SAP acquired it in 2011 for $3.5 billion (11.9x LTM).
- Taleo finished second when Oracle acquired it in early 2012 for $1.9 billion (6.2x LTM).
- Kenexa finished third in the category when IBM acquired it in mid-2012 for $1.3 billion (4.1x LTM).

Even though SuccessFactors and Taleo were similar in size in terms of revenue, SuccessFactors came in first and commanded the premium in part because of its willingness to invest in sales and marketing — 47 percent of gross revenue in 2011. This investment eclipsed the level of investment of Taleo (36 percent in 2011) and Kenexa (23 percent in 2011).

You can look at SEC filings for companies across enterprise technology and HCM software in particular. We have. These trends hold up over time. It's something we believe in like we believe in electricity. It just is.

Does Globoforce's IPO postponement mean trouble for HR technology companies?

We believe that a lack of understanding in the broader market could create collateral damage in enterprise technology companies that focus on HR and HCM. But that shouldn't be the case. There are many good companies with solid fundamentals and real solutions that create value for customers who understand how the market works and operate accordingly. If you look at two of the bellwethers of the market — Cornerstone OnDemand and Workday — their stock price growth trajectories are aligned with the broader NYSE and NASDAQ indexes over the past

12 months. And even though LinkedIn's stock price has seen a gradual slide since September, its stock price is up over the past 12 months.

Do you think there's investment fatigue in HR technology? Think again. In 2013, human capital management technology startups grabbed $600 million across 208 deals, according to CB Insights. Money continues to flow into this market, in part because the payday doesn't necessarily have to come after an IPO — 67 percent of tech exits in 2013 went to early stage startups. However, the IPO remains the goal for many companies, and operating at a loss will be the reality for these companies.

A quick overview of rewards and recognition companies

Before looking specifically at the Globoforce S-1, it's important to understand the company's category and its place in it. We believe that recognition has significant potential to improve employee engagement. Upstart brands have garnered industry attention by connecting this idea to sexy topics such as social technologies and engaging Gen Y employees. However, the rewards and recognition industry isn't a new one. Many heritage brands in the category are 50 to 100 years old, and most started out as manufacturers of the proverbial gold watches.

- **The heritage brands:** Companies such as Inspirus, O.C. Tanner, Rideau, and others established the idea of using rewards for recognition and usually have significant investments in manufacturing and fulfillment. These companies are typically privately held, profit-focused enterprises.
- **The upstart brands:** The technology startups such as the two category leaders, Globoforce and Achievers, promote the social and peer-to-peer aspects of recognition as a means to drive engagement. These companies function like fast-growth tech startups and focus on grabbing market share at the expense of profit.

One key distinction between the two groups is in their billing models and how they recognize revenue. Every company has its own spin on this, and no two are alike. Understanding the differences is important to understanding the complexity of the model. Generally speaking, there are two primary billing models:

1. **Billing on issuance.** Globoforce and Achievers use variations on this billing model. In this scenario, a client typically either purchases or negotiates "points" from a vendor upfront or budgets for a set amount. Employees can earn points that can be redeemed for gift cards or merchandise. This model makes it easy for clients to budget. It's also favorable for fast-growth startup companies because they can recognize the revenue immediately. The vendor also likes this model because it gets to keep the "breakage" — the unredeemed value of the points. It's generally accepted in the industry that 10 to 15 percent of all points are never redeemed because of turnover, people forgetting, leftover points, etc., which creates pure margin for the reward vendor. And it can even be a slightly higher percentage — close to 20 percent — for gift card rewards. The downside is the reward vendor is on the hook to pay. This risk can create the scenario of what happens in the (unlikely) event that all of the unredeemed points were suddenly redeemed — a "run on the bank" of sorts. How unlikely is this? About the same risk as your homeowner's insurance company not being able to pay you because everyone they cover filed a claim at once. We believe that buyers should understand what they are getting. We believe that any vendor with a deferred cash liability issue can address the issue in one of two ways:

    - **A cash reserve.** For other companies in this category, a secure cash position will go a long way toward heading off market concerns.
    - **An investment algorithm.** The odds of a proverbial "run on the bank" are fairly slim for any rewards and recognition company. However, it is a concern that comes up with investors during transfer events, and we feel that the industry needs to address this issue. One solution is an algorithm — not unlike the ones insurance companies use to account for risk — to predict the likelihood that a certain number of points would be redeemed at a given time.
2. **Billing on redemption.** Most heritage brands use this model. In this scenario, a client only pays when points are redeemed (cashed in by the end user) for gift cards, merchandise, cash, or travel and any breakage goes back to the client. If an employee doesn't redeem points they earn, the company essentially gets the points for free, so the reward company has an incentive to get employees to use the points. Although this relationship is great for the client, it's a much more difficult for the reward vendor because much of the profit in a deal isn't realized until several years into an engagement. There is no cash liability to the vendor if they maintain the customer relationship.

A look at Globoforce's S-1 filing

According to the Globoforce SEC filings, the revenue from redemption in 2013 — $167.8 million — more than offsets the cost of redemption revenue — $145.5 million. The $6.5 million net loss on the consolidated statement of operations actually seems pretty modest for a fast-growth enterprise technology company knocking on the door of $200 million in gross revenue. And a $0.24 net loss per share in 2013 attributable to ordinary shareholders is actually much better than Cornerstone OnDemand ($0.79 for 12 months ending Dec. 31, 2013) and Workday ($0.68 for nine months ending Oct. 31, 2013).

	Year ended December 31,		
(in thousands, except per share data)	2011	2012	2013
Consolidated statements of operations data			
Revenue			
Redemption revenue	$ 123,015	$ 141,136	$ 167,841
Solution and services revenue	12,790	16,555	18,956
Total revenue	135,805	157,691	186,797
Expenses			
Cost of redemption revenue	106,827	123,240	145,515
Cost of solution and services revenue	2,025	2,586	3,209
Operations	3,363	3,735	4,367
Research and development	8,933	9,285	10,160
Sales and marketing	11,097	16,862	21,924
General and administrative	3,241	4,186	6,198
Total expenses	135,486	159,894	191,373
Income (loss) from operations	319	(2,203)	(4,576)
Other (expense) income, net	(827)	828	(1,317)
Loss before income taxes	(508)	(1,375)	(5,893)
Provision for income taxes	296	461	655
Net loss attributable to ordinary shareholders	$ (804)	$ (1,836)	$ (6,548)
Net loss per share attributable to ordinary shareholders—basic and diluted	$ (0.09)	$ (0.21)	$ (0.74)
Weighted-average number of ordinary shares used in computing net loss per share attributable to ordinary shareholders—basic and diluted	8,741	8,754	8,815
Pro forma net loss per share attributable to ordinary shareholders—basic and diluted(1)			$ (0.24)
Weighted-average number of ordinary shares used in computing pro forma net loss per share attributable to ordinary shareholders—basic and diluted(1)			23,789

(1) Pro forma basic and diluted net loss per share has been computed to give effect to the conversion of all redeemable convertible preferred shares into ordinary shares and the conversion of all previously outstanding warrants to purchase redeemable convertible preferred shares into warrants to purchase ordinary shares, as if such conversion had occurred as of the date of original issuance. The impact of the accretion of unpaid and undeclared dividends has been excluded from the determination of net loss attributable to ordinary shareholders as the holders of the redeemable convertible preferred shares are not entitled to receive undeclared dividends upon such conversion. Additionally, the gains (losses) associated with the changes in the fair value of the previously outstanding warrants to purchase preferred shares has been excluded from the determination of net loss as these remeasurements would not be required when the warrants to purchase preferred shares would have become warrants to purchase ordinary shares upon the closing of this offering.

However, as it is with many cloud software companies, there are areas of opacity in SEC filings. We get it: There's a fine line between giving the market the information it needs and disclosing business secrets. We believe that the Globoforce S-1 disclosed everything appropriately, but we think there were areas where clarity could be improved:

- **Pass-through revenue:** Pass-through revenue is a concept that the market gets. There are plenty of publicly traded advertising agencies. However, it takes careful reading to understand that although gross revenue is around $186 million, net revenue is only about $41.2 million.

- **Solution and services revenue:** Of the $41.2 million in net revenue, $22.3 million is in redemption revenue and $18.9 million is in solution and services revenue. Most SaaS technology companies indicate percentage of revenue from software subscriptions. We would recommend Globoforce do the same and separate professional services from software subscriptions.
- **Deferred revenue:** Globoforce's deferred revenue of $78 million should be an advantage for the company, and the S-1 indicates that there are no major liabilities. However, it also states: *"Amounts in deferred revenue related to the Redemption of Rewards are classified as a current liability, as the amounts are subject to immediate redemption by the client's employees."* Given the realities of the bill-on-issuance model and the lack of clarity around specific line items, it opens the door for confusion. As we said before, investors don't invest in things they don't understand. There's enough ambiguity here to give an investor pause.

Do these facts indicate a problem with the business model? Not at all. We think Globoforce is a solid company. According to the S-1, it has $17 million in cash on hand, more than $40 million in accounts receivable, a history of positive cash flow, and a track record of profitability in 2009 and 2010, before it started funding sales and marketing for aggressive growth. Its breakage appears to be far lower than the industry average of 10 percent. The company has a number of other advantages: a strategic partnership with Workday, one of the best global fulfillment systems in the industry, and a customer relationship with GE (the gold standard in talent-forward companies). Globoforce has also been willing to invest in sales and marketing because it wants to win its category — that's a big plus.

However, there are other risks. Globoforce gets 10 percent of its revenue from GE, and its 10 largest clients represented 68 percent of its 2013 gross revenue. For an industry where the barrier to change is low, it's not a risk that can be overlooked. Closing more deals and distributing revenue across more clients would mitigate this risk.

One of the most significant challenges that Globoforce faces is reshaping its go-to-market narrative. To someone who understands the category and how enterprise software companies work, Globoforce looks like a traditional rewards company that is trying to be a fast-growth technology startup. If it wants to be a rewards company, Globoforce is on the right track. However, we believe there are no publicly traded rewards companies for a reason: It's a great business for a profit model, but not so much for a growth model. If Globoforce wants to be fast-growth technology startup, it needs to focus more on telling that story through its financials. Year-over-year growth in the 20 percent range isn't going to cut it. Eyes in the market will be on Globoforce's growth over the next few quarters, if it does intend to IPO before year end.

How does this impact the rewards and recognition segment?

In the battle for market share in the recognition category, the upstarts may lack the resources of heritage brands, but they are winning the battle for hearts and minds by positioning the establishment as technology laggards. Even though heritage brands are working to hold their own and develop technology that is often much better than the upstarts, the majority of the headlines still go to Globoforce and Achievers. How does the race to grab market share and win the category now stand and what do the players need to do now to seize the initiative?

For Globoforce, it will be important to change the conversation and regain momentum. Globoforce needs to establish a go-to-market narrative that makes sense to investors: Decide whether you are a rewards company or a tech company and then be that. With its current financials, the company is telling the story of a rewards company. If it wants to be a tech company, Globoforce needs to increase clarity in its financials and clarify how software subscription, services, and reward redemption revenue (including breakage) are delineated. Cutting sales and marketing budget to make the numbers more suitable for investors would not be a formula for success. Even after everyone viewed the "lack of suitable market conditions" rationale with skepticism, it turns out that there's a lot of truth there. As *The New York Times* pointed out on Sunday, it's currently a turbulent market for IPOs and there is evidently some investor fatigue around cloud software in general. Globoforce has an opportunity to educate the market on the rewards and recognition category and explain why it is so dynamic. You can always tell the pioneers by the arrows in their backs. Globoforce has certainly taken theirs. How Globoforce responds will not only determine how the company fares in having an IPO this year, but it could also have a broader impact on the market for HR technology and services companies.

For Achievers, they have an opening for now in the race to win the category. With no announced plans for an IPO and the benefit of not having financials to scrutinize, they can see where some of the land mines are in the market when and if that day comes. In an interview, Achievers founder Razor Suleman said that he believes his company understands the issues and took steps to address them when they became a Sequoia Capital portfolio company in 2011. "We believe in the power of social recognition so much so that 64 percent of recognition on our Employee Success Platform is non-monetary," he said. But is changing the company's focus to recognition from rewards the right course — and will the market get it? "Even if you disassociate yourself from the rewards, the customer is still going to hold you responsible. That's the reality," said Peter Hart, CEO of Rideau Recognition Solutions.

For heritage brands in the space, they have become accustomed to the increased scrutiny over the past few years as the IRS has taken a closer look at how reward programs are taxed. Most of the CEOs at leading companies in the category who we have spoken to actually welcome the increased oversight because they feel it will weed out some of the more unscrupulous companies in the space. However, the billing issue isn't one that any of these companies can ignore. Any company looking to sell or be acquired is going to go through the same due-diligence process and face the same intense scrutiny over revenue recognition as they would in an IPO process. These companies also have a different take on winning the category. They want to grab market share, but they are about profitability, not navigating toward an exit. They will never overspend on sales and marketing at the expense of profit. As a result, expect lots of FUD — fear, uncertainty, and doubt — to find its way into sales and marketing messaging. The heritage brands that have been suffering on the other side of the messaging and positioning divide may have finally found an issue — proven business continuity, stability, and profitability — that will help them regain an advantage against the upstarts. "If nothing else, this situation reinforces the idea that rewards and recognition isn't a software play," said Paul Hebert, a thought leader in the rewards and recognition industry and a vice president of solution design at Symbolist. "There's an intangible factor that can't be put into bits and bytes and can't be factored in. And the revenue potential from rewards far outweighs the potential from the software part." Although we don't share this point of view, it's hard to argue against this perspective until a tech-first company shows they can succeed leading with software rather than rewards.

How does this impact enterprise technology companies focused on HR/HCM? It would be easy for companies across the industry to dismiss the Globoforce situation as a one-off and not relevant to them. After all, rewards and recognition is a different thing, right? And HR technology is one of the hottest segments of enterprise software — solving real business problems for real clients and producing real revenue. So, what's the problem?

The problem is belief. There's a need for faith when investing in a fast-growth cloud-based technology company. Even though many people in the industry dismissed Globoforce's comment about unfavorable market conditions as spin, the reality is that many investors don't get the growth model, and the market is so crowded that investors don't always take the time to fairly evaluate complex business models. In enterprise software, expect more pressure for publicly traded cloud companies to turn a profit. Even salesforce.com — the company that started it all in the cloud — is feeling the heat and is on track to post a profit for the first time this year with an assist from non-GAAP accounting. Don't underestimate the gravity of the moment. Many of the most highly sought-after investors — the long-term institutional funds — are sitting on the sidelines for now, waiting to see what happens. Leaving the market to the short-sellers and hedge funds won't be a positive in the near term.

For our industry, now isn't the time to just go whistling past the graveyard and pretend nothing's going on. There's a need to educate both investors and buyers. There is a lot of value in HR/HCM technology to be created for them both. We believe in recognition as a category. It's one of several exciting innovative areas, such as wellness and casual learning, that have a greater potential to increase employee engagement and effectiveness than traditional HCM approaches. Investors need to understand these businesses so they can truly evaluate them. Buyers need to understand how they work so they can know what they're buying. Understanding and clarity can go a long way toward turning around this crisis of confidence and prevent it from becoming a true crisis.

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Disclosure: No active clients of The Starr Conspiracy in the rewards and recognition category are mentioned in this report. Past clients mentioned in this report include Globoforce, Achievers, and Inspirus.