Investors' Chronicle | Alpha

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Alpha shares analysis

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Change management is key to unlocking new growth

Our stocks this week have had strong growth records, but the investment cases rest on whether the respective management teams can deliver on hopes and promises to develop new business lines utilising more dynamic technologies.

Analyst: **Robin Hardy**

- **Boku (BOKU)** – Boku is a mobile payments processing business and the bulk of its profits still come from the Carrier Billing sector. This is where ad-hoc or non-recurring payments primarily in entertainment streaming services are charged through a mobile phone. Boku is a key provider to industry majors such as GooglePlay and Spotify, but these markets are maturing. Future growth, therefore, is sought from the more nascent and dynamic sectors of digital wallets and account-to-account (A2A), disintermediated payment systems. Early momentum achieved in these new areas must be sustained to see the business make good on apparently huge potential and for the shares, which are rated on a 27x PE, but have flatlined in 2023, to do likewise.

- **ServiceNow (NOW)** – NOW is a major player in the cloud computing market, although the space remains dominated by the 'Big 3' (Amazon Web Services (AWS), Google Cloud & Microsoft Azure). It offers the less common Platform-as-a-service infrastructure – which looks set to benefit most from the arrival of Artificial Intelligence (AI) and machine learning. Growth in cloud computing has slowed fairly sharply, but NOW looks to be bucking the wider trend, although the forecast rate of profit growth (18 per cent) is below the average of the last five years (30 per cent). A strong business but potentially overbought, meaning that investors should wait for the shares to ease and look for something in the $600 to $625 range.

ServiceNow – bucking the cloud slowdown?

Source: FactSet | NB: Logarithmic scale

ServiceNow (US: NOW) is a leading cloud computing business focused on enterprise-level solutions in IT service management. It runs a platform-as-a-service (PaaS) subscription model for more than 7,500 enterprises, collecting almost $7bn in annual service subscriptions. The compound annual growth rate (CAGR) of Its customer base has exceeded 30 per cent over the last five years (note, however, that NOW is a highly acquisitive business making 22 substantial deals in the last 10 years) and margins are high at 27 per cent at the EBIT (earnings before interest and taxes) line.

Total shareholder return (TSR) has averaged more than 25 per cent over the last five years (all capital – no dividend is paid) and the share price has now exceeded its previous highpoint reached before the 2021 tech sell-off. Many Nasdaq-listed tech companies remain 10-20 per cent below those peak levels.

The market cap is above $140bn and, unusually for a tech business, it is listed on the NYSE rather than Nasdaq.

Operations and divisions

So what is PaaS? It is a complete hardware and framework software development and deployment environment hosted in the cloud, replacing in-house installation or local server farms. PaaS provides resources to build and operate anything from simple cloud-based apps through to sophisticated enterprise-wide applications. A typical PaaS will provide: development tools, database management, business analytics, hosted operating systems, servers, storage, networking and firewalls & security across devolved and distributed locations to ensure continuity. It brings the standard advantages of any as-a-service mechanism: elastic capacity, fast deployment, lower cost and on-demand additional tools.

The key difference between PaaS and the more common SaaS (software) is that the management of data and applications remain fully under the customer's control. Data can, for example, be integrated through another cloud platform such as Oracle or SAP.

Applications can be either own-generated, other licenced instals or a third party cloud-hosted software. Other examples of enterprise-level PaaS would be AWS Elastic Beanstalk, Microsoft Azure, Heroku, Force.com, Google App Engine, Apache Stratos or OpenShift.

There are four main operating channels in the group although there is no segmentation or financial data along the lines of reporting shown below. All of these functions run on the same, 'NOW Platform' using common modules such as low-code programming, machine learning, robotic processes, analytics, virtual agents/AI bots, encryption/blockchain and third party integrations (middleware).

- **Technology workflows** – this is the heart of the business and the largest revenue block delivering, we estimate, 70 per cent or $5bn of the total billings. This branch deals with core, bread-and-butter IT services (such as hardware, networks, storage or backup), operations management, security, risk management and, more recently, ESG (environment, social and governance factors).
- **Employee workflows** – this deals with HR and legal functions along with tools for hard asset, fleet, plant, buildings and facilities management. This branch generates around $650mn of billings or 8-10 per cent of the total.
- **Customer and industry workflows** – this module provides tools for CSM and FSM (customer and field service management) along with a nascent, focused suite of industry-specific, tailored tools for TMT (technology, media and telecom), financials, manufacturing, healthcare, life sciences and the public sector. Billings total around $800mn or c.12 per cent of total inflows.
- **Creator workflows** – this is where both more complex, coded applications and staff-generated apps or micro-specific tasks can be created using modular no/lo-code tools – so-called 'citizen development'. This allows for the development

of workflow tools from department, through team and even to individual levels. Annual billings run at around $850mn.

These are the established silos on the NOW Platform, but as the IT environment evolves, new capabilities are being added, with two areas the prime focus for now.

- **Public sector digital transformation** – generally the public sector significantly lags behind the commercial sector in cloud migration and, more broadly, the digitisation of workflows and data management. The transformation is now taking hold, making this one of the fastest growing areas within IT, growing at 30-35 per cent CAGR in the last five years. NOW believes that this sector alone has the potential to generate $1bn of annual billings.

- **Generative AI** – we cannot look at any IT business for long without coming across AI, machine learning and robotic processes. NOW has been assembling by acquisition a comprehensive range of AI tools (nine in total) that are being worked into many existing modules, alongside standalone cloud AI functionality. This is unlikely to be visible as a standalone in billing terms but is likely to be pivotal in maintaining new customer acquisitions and continuing the process of having existing customers buy into more tools.

Analysis and conclusions

Strong tailwinds – PaaS looks set to remain a strong market throughout this decade with industry forecasters predicting annual expansion at 16-21 per cent, rising from total billings of $82bn in 2022 to $275bn by 2028. The key drivers are ongoing digital transformation of increasingly smaller businesses, the major catch-up in the public sector, some movement away from SaaS to PaaS, as this gives more control over application development, rapid expansion of the Internet of Things (IoT) sector and, increasingly, the desire to access 'out of the box' or modular AI solutions.

Alliances – This industry tailwind is augmented by NOW's drive to sell more services to existing customers and get more closely aligned with the fastest growing sectors. This will be alongside bringing in more customers both from cold selling, by provisioning integration with a growing number of technology partners (such as Nvidia or Hugging Face in AI) and more strategic partnerships with systems integrators and consultancies. There is to be a greater push for new customers outside the US, which still drives around two-thirds of billings.

Big ambition – The net result is an ambition to double revenue between 2022 and 2026 to $15bn – that may sound bullish but at 18 per cent CAGR it is both lower than the nearer 30 per cent seen recently and is only in line with the expected growth in the PaaS sector. NOW is also promising better margins (around 200 basis points better from 26 to 28 per cent EBIT) and sharply lower use of share-based remuneration, which has had a minor drag (along with acquisitions) on the earnings per share (EPS) growth. However, there is likely to be increasing foreign exchange exposure as more of the business will be operating with non-US dollar billings. Another potential issue with that delivery is the 'deal elongation'. NOW has already reported that acquisitions are taking longer to close and face more competition and bolt-on capability has always been a core growth driver.

Maturity – Why should growth now fall to only be in line with industry expansion? This is a maturing industry and many of NOW's larger customers are likely to be reaching saturation in the core, bread-and-butter IT space, meaning that the burden of delivering the growth has passed to the smaller business lines, especially AI. Focusing on lagging sectors such as the public sector is sensible, but this is going to be the strategy of all players in the cloud space and risks having a drag effect on billing rates.

Congestion and cannibalisation – The same is true for AI with a concentration of effort by all players plus, as this is a new and very different field from more standard cloud computing, there are more players fighting for the available business. The recent strategic tie-up with field leader Nvidia is helpful, but there is a risk of pricing pressure. Another issue with AI and ML is potential cannibalisation and possibly the eventual elimination of some more basic IT service requirements within the still dominant technology workflows arena. AI and ML have a habit of highlightling business inefficiency and waste.

Lack of opportunity – Another sign of potential maturity, and also perhaps difficulty keeping down the costs of acquiring customers, is NOW's decision to switch its use of capital to a first share buy-back programme. Although small at $1.5bn, it is always a pivotal moment when any business, wholly focused hitherto on growth, begins to distribute rather than invest. This is not automatically a negative sign, but does support the idea that growth is likely to slow.

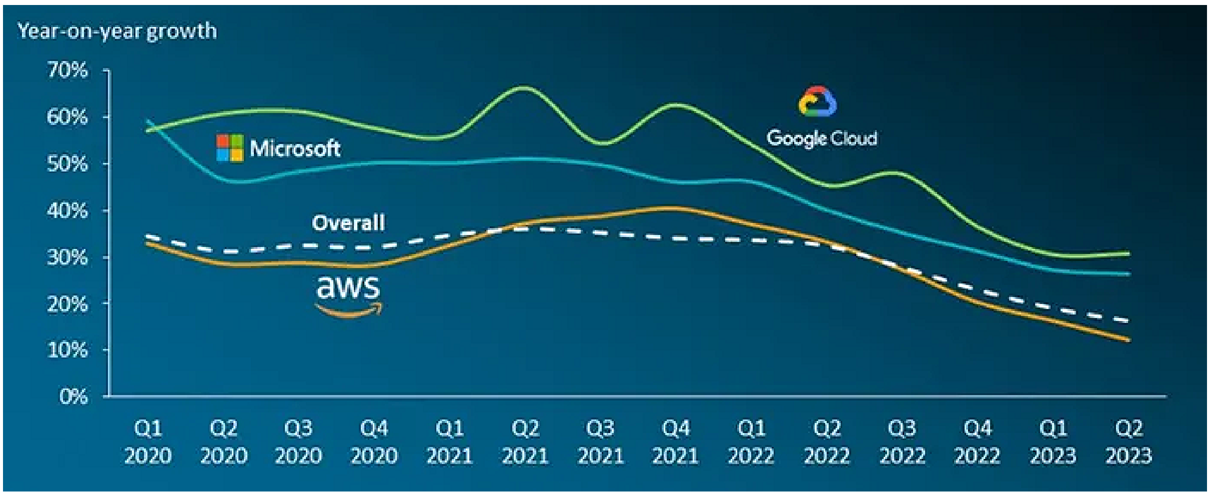
So this is a good investment story with high growth markets and the promise of a large pick-up in profits, but is there still value? A lot of any potential value would have been consumed regardless by the more than 25 per cent surge in the share price following the Q3 results, which proffered higher profit guidance.

That said, against the Q2 indications, subscription revenues were only edged up by 0.7 per cent and were just 2 per cent higher than indicated at the start of the year. EBIT margin indications are better (27 vs 26 per cent) and there is likely to be less dilution from share-based remuneration, meaning EPS could be 6-8 per cent higher than expected.

These are not really the sorts of changes, per se, that would drive up a share price by a quarter. However, it is more the direction of travel that is important. Elsewhere in this space, guidance is not ticking up (in some cases it is getting more cautious) and overall the cloud-computing market is not hitting expectations. NOW, therefore, has bucked the trend and that is always likely to inject some excitement.

But this much? The rally in the last six weeks feels overdone and the rating on a 54x PE (Dec 24) and EV/Ebitda (enterprise value to earnings before interest, tax, depreciation and amortisation) of 41x does look pretty demanding. That means that any wobbles from here on, however slight, risk seeing the share price punished. This rating also leaves the shares rated materially higher than comparables such as **Intuit (US:INTU)** or **Workday (US:WDAY)**.

Growth rates in cloud computing – the 'big 3'



Source: Canalys August 2023

Analysts almost universally have positive calls on the stock, but in most cases their target prices are lower than the current share price. This potentially triggers a step back in investment advice from positive to neutral and that suggests that the shares are likely only to mark time for the next few months. The hope in this space rests in proving that AI is going to have the transformative impact the market is hoping for.

NOW has aligned itself well with Nvidia, but there is a lot of froth in this area bumping valuations.

It does feel as if the growth on offer is overpriced both per se and against the group's own valuation history. Growth is slower, there are more risk factors coming to bear and, with the still 70/30 bias towards more standard IT solutions (where expansion rates are sharply decelerating), investors need to be very confident that this does not become a drag. At close to $690 per share, NOW looks 5-10 per cent over-valued and if the investment story does appeal, then paying no more than $600 to $625 seems more sensible.

BOKU – global and local payment solutions

Source: FactSet | NB: Logarithmic scale

Boku (BOKU) is an Aim-traded, US-domiciled, globally-spread (in 29 countries) mobile payments processing software company. Its platform is primarily used for Direct Carrier

Billing (DCB) but is being re-tuned to also process what are known as 'local payment mechanisms' (LPM), largely running on mobile devices.

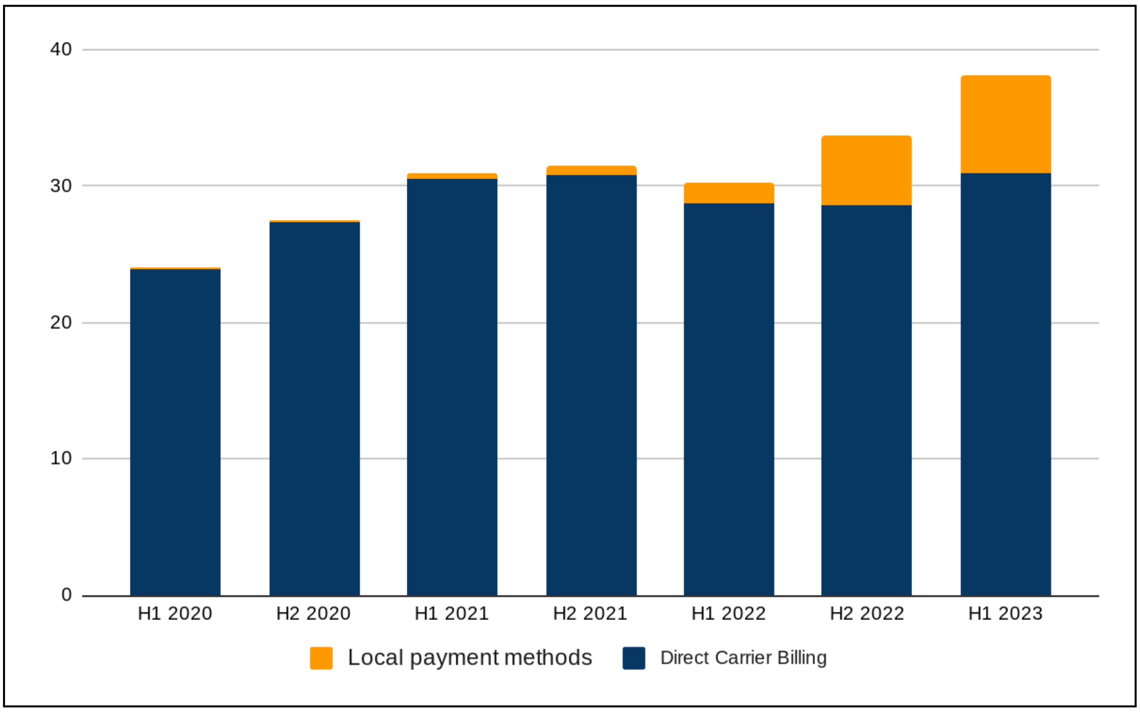
While DCB as a sector is only growing at a moderate rate, the five-year CAGR of Boku's revenues is above 20 per cent (£51mn last reported and £62mn forecast), with the business turning EBIT positive in 2020. It is now delivering EBIT margins of around 25 per cent, out of fairly typical gross margins from software above 85 per cent.

The market cap is around £425mn and TSR has averaged c.15 per cent across the last five years (all capital – no dividend), although it did shed two-thirds of its value in the late 2021 tech/growth stock sell-off. The share price has since doubled but year-to-date has been relatively flat.

Operations and divisions

Boku operates across three types of consumer payment/merchant payment collection, running largely off a common, global platform. Boku has not historically split its revenues by the three sources listed below (largely because 95 to 99 per cent was from Carrier Commerce) but in the latest interim results, the first split was given (see below).

Boku revenue split – $mn



Source: Boku

In all business lines, revenue is generated by collecting a small slice of the client's revenue passing through the Boku platform (known as the 'take rate') and on the core Carrier Billing service this is typically around 0.73 per cent.

Carrier commerce – also known as Direct Carrier Billing (DCB), this was the original base of the business and, while it remains substantial, it is only showing modest growth and did dip after the Covid lockdown ended (unsurprisingly as revenues are dominated by entertainment streaming). That said, the revenue base (mainly large global content and entertainment providers) is very 'sticky'.

Boku has some very significant clients such as Apple AppStore, Google Play, iTunes, Microsoft, Meta, Netflix, Spotify and Amazon from whom it collects non-recurring/ad-hoc revenue and small physical product payments (below €50 under EU regulations) via a mobile phone app or other online mechanisms. This is usually distinct from the core service provision or subscription revenues which are handled by large enterprise content management (ECM) systems such as SAP, although some providers (notably Netflix) do use Boku's platform for subscriptions in some markets.

Collection of these revenues can be complex and the simplification of authorisation, billing, payment and onwards redistribution of revenues is the great strength of Boku's platform. It is both flexible and scalable (it largely operates in AWS, using elastic server capacity). Historically, additional service payments would need to be handled via a manual card payment intervention, which was cumbersome and had trust issues in some markets.

The market outlook more broadly for DCB remains positive with industry forecasts indicating over 10 per cent CAGR through to the end of the decade, but it is possible growth rates will tail off fairly steeply by the end of this period. This is a relatively mature market and conversion of traditional payments to DCB rather than core volume growth will drive expansion. Entertainment streaming is a big industry, but is seen as being relatively small relative to overall consumer spending, as we discuss later, an area of newer focus for Boku.

Local payment: wallets – a digital wallet is a software, typically running on a smart device that facilitates financial transactions electronically and seamlessly. The wallet stores the vital user's information for different payment cards, travel permits, loyalty schemes, website-specific data & permissions, gift cards, entry passes and sometimes personal ID such as a driver's licence. It does what it says on the tin, becoming a virtual wallet to save users having to carry all of their cards all of the time. The wallet itself does not provide the financial service and users must have an account or service with an intermediary, usually the card issuer.

There are different types of wallet available:

- **Closed** – funds stored to make transactions with only the issuer of the wallet. The money from cancellations, returns or refunds is stored in the wallets. Amazon Pay is an example of a closed wallet.
- **Semi-closed –** limited and specific transactions at specific merchants or providers – mobile phone companies, utilities, cinema bookings etc.
- **Open** – the type of digital wallet most people would recognise, from the likes of Apple or Google Pay, where the wallet is an effective replacement for a universal payment card. This is slightly less open than Visa or Mastercard physical cards as each card issuer must decide whether or not to allow wallet use.

The Wallets business is the major part of the group's local payment revenue and has grown very rapidly, most recently posting a 350 per cent annual increase in half-yearly revenues (H1 2023 vs H1 2022). In that period it accounted for approaching 20 per cent of total revenue.

Local payments: A2A – Account-to-account (A2A) payments are those made directly between two bank accounts without an intermediary like a credit card company or third-party financial institution or processor. The A2A market is already considerable with an estimated $525bn of money moved in 2022, a figure expected to rise ay 13 per cent CAGR through to the end of the decade.

A2A is part of the long-term drift away from cash, and even traditional card use. It is increasingly used to take payments by smaller merchants, attracted by the absence of intermediaries, lower transaction costs, instant settlements, very high security (fewer nodes in the process) and the natural advantages of 'frictionless payments' (the shopping process and the payment are all on the one device) such as speed, ease-of-use and lower 'shopping cart abandonment'.

While the origins of A2A were typically in less economically developed nations and those lacking a well-established and trusted banking system such as Africa, India and emerging Asia-Pacific, adoption is accelerating now in western economies. In the EU, the EPI (European Payments Initiative) has opened this market and in the US, the Federal Reserve is rolling out the first users to test the 'FedNow' instant payment service. In many end markets, failure by merchants to embrace A2A is often seen as harmful to their business.

This is at a very early stage for Boku and accounts for only a tiny fraction of the overall revenue but most likely has the greatest maximum potential and highest potential rate of growth.

Analysis and conclusions

The old core of the revenue base is slowing (but still growing) and given the exposure to consumer spending, it is unsurprising to have seen the share price move sideways this year and for what had been a fairly steady upgrade cycle to top out. In the last couple of weeks the consensus has actually edged down slightly. The business is leaning more heavily on LPM to drive its growth, although this remains relatively small in a group context. The market is far from certain just how successful Boku will be in growing this revenue stream.

Old core slowing? Yes but….

The revenues arising from the group's large, global customers in DCB look to be stable but less able to drive growth in the way they have. The market still has potential but, into tougher times for home finances, subscriptions and ad-hoc entertainment spending is under pressure.

Boku should be able sustain some growth in the core DCB lines by penetrating more of the services from its larger customers. Take Microsoft as an example: Boku collects revenue from 365 and the xBox store, but not from Linkedin Premium, Linkedin Ads, Bing Ads or Azure. The same is true for Amazon: Prime video is active but music, Kindle, AWS, Ads and the core retail arm (which would only be refunds and gift cards primarily) are not active. Overall, Boku collects revenues from only 15-20 per cent of these large customers' revenue streams.

Bigger pools

The DCB market is substantial at around $300bn of consumer outlay annually. However, digital wallet and A2A are driven by global consumer spending and B2B payments, which are orders of magnitude larger. The global B2C spending pool is estimated at $13tn, more than 40 times larger and B2B spending 3-4x larger again. In both of these segments e-commerce continues to take market share and non-traditional payment methods are growing in prominence. So, the markets to which Boku is now looking to drive growth are much larger and Boku's modes of access are growing 2.5x faster than in existing markets. This means that Boku has only to be relatively successful in this space to bring through enough revenue to deliver the market's target growth.

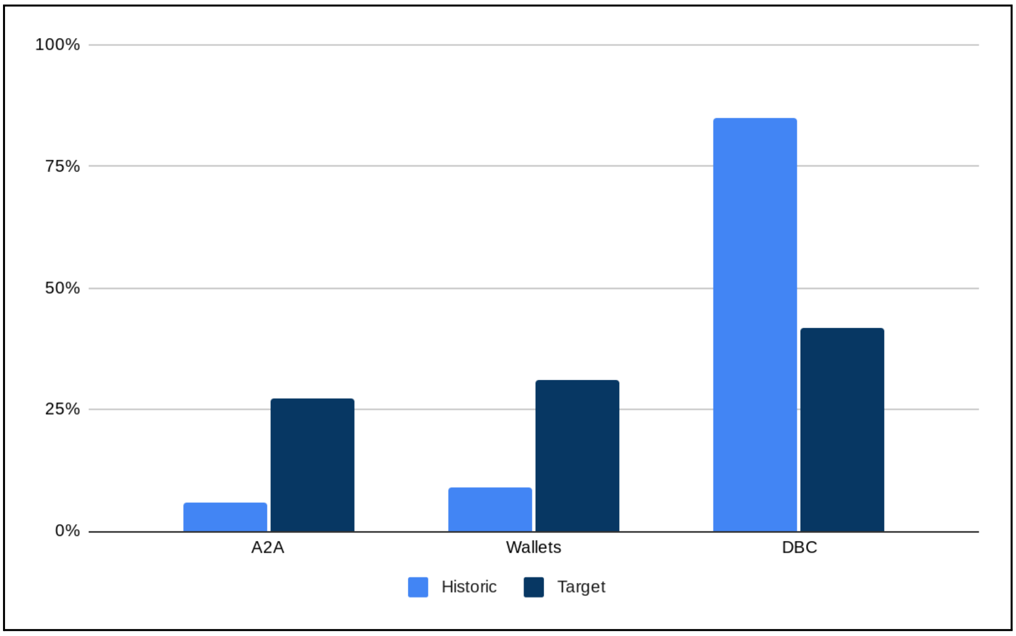
LPMs ascendant

As hard cash, and even traditional card-use, dwindles as a share of total spend, new payment mechanisms are in the ascendancy and there is every indication that Boku's DCB systems can be tweaked and adapted to operate well in this space. There will likely be more competition but Boku has the advantage of already being well established with banks, card issuers (still key for wallets) and can provide turnkey solutions for new FinApps in the A2A space. As these are B2B and B2C oriented, even modest market share would mean very decent money flows. However, that is only part of the story.

Take rates

Not only will the growth in LPM add to the pool of revenue, the take rates for Boku are expected to be higher than in DCB. This is largely due to there being many smaller players with less leverage to dictate tight pricing levels.

Predicted progression of Boku's revenues



Source:Boku

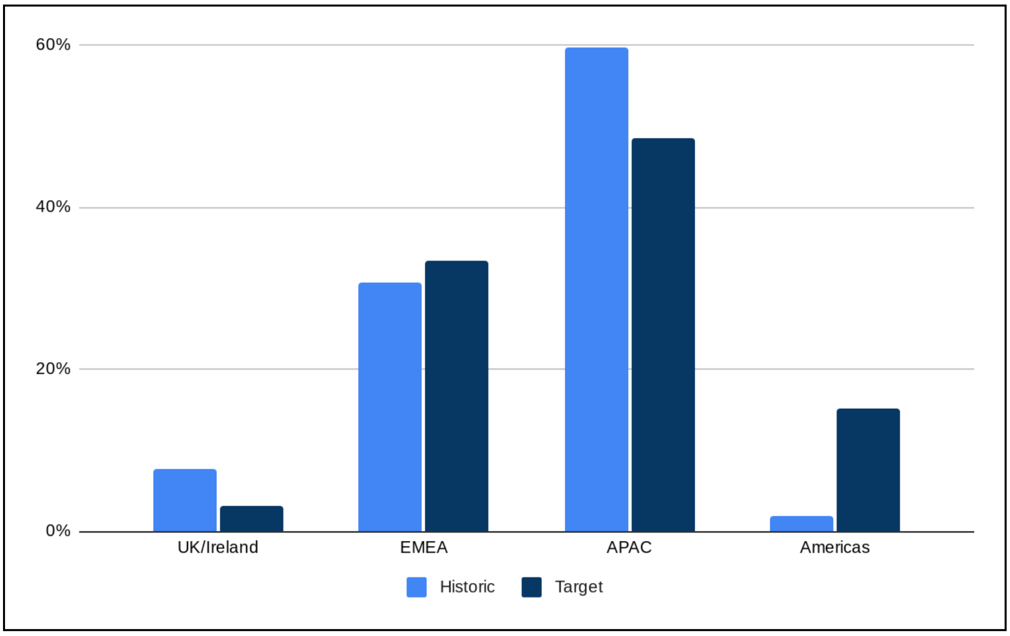
Operational gearing

We mentioned that Boku's platform is flexible and scalable. This has already been demonstrated by the group taking the rapid expansion in its wallets business in its stride and its ability to grow its operating cost base (its opex) by less than the rate of revenue growth. Going forwards, it is expected that this gap should be able to widen, which should allow more of the high gross margin to fall through to earnings.

Broader geography

Historically Boku's revenues have had a sizable bias towards Asia Pacific along with EMEA (ex UK and Ireland) – together these have accounted for 95 per cent of revenue. These regions are expected to remain dominant but the target revenue split (in five to 10 years) looks quite different. APAC and EMEA (Europe, Middle East and Africa) are likely to remain dominant but the Americas (most likely South rather than North) should play a far bigger role. A better balanced business should allow for higher quality of earnings.

Changing revenue bias



Source: Boku

Improving quality of earnings?

There looks to be plenty of growth potential although the market rightly wants to see that rebalancing of the revenue base, plus the targets of doubling revenue and driving up Ebitda margins to 50 per cent are realistic, within the four to six-year timeframe management believes possible.

Such growth would be accompanied by a rising quality of earnings (QoE) – better balance by business line, better geo-split and greater efficiency narrowing the gross to net margin gap. It is possible to argue that, even if revenue did not grow materially, this better QoE alone could be enough to drive a decent level of TSR on a five year timeframe.

Conclusions

Boku has scope to deliver growth from several directions which, plus the growing QoE, make this a solid looking investment, on paper at least. We are looking at a lot of change and repositioning with an accompanying set of new risks, whereas the old structure focused on DCB was stable and well understood. Markets are generally wary of sizable change. The LPM market does appear dynamic but all too often the potential itself or the timescales of the 'next big thing' can become overblown.

Luckily, the valuation has not been distorted by hoped-for positives and has instead assumed a healthy amount of caution and reserve. Forecasts are actually edging down slightly in late 2023.

That said, the stock is not that cheap on a PE of 27x, but growth is set to run at 17-20 per cent. This is well above the UK market's 7-10 per cent and the market trades on a year 1 PE of 11.5x so a decent premium is well-supported. If there is clear evidence that the forecast growth on LPM continues then there is scope for upgrades (the January full-year trading update will be key) and, at the moment, we are seeing very positive share price reactions to even fairly moderate beats and/or improved guidance.

For now there looks to be no rush to buy in and, while the stock is not too expensive, it does feel fully valued with an inclination to believe that growth is still being under-estimated. Investors are best advised to hang on for stronger evidence that the transition towards LPM can deliver the multifaceted benefits the board thinks possible but downside is likely to be limited.

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