Notes from Hadoop World

We recently spent time at Hadoop World and remain convinced that Hadoop and other new open source-based data management technologies are going to be increasingly disruptive to legacy data management providers like ORCL and TDC.

Macro Issues May Drive Hadoop Adoption, But Better Functionality is Sustaining it.

Recent and repeated top line shortfalls from ORCL ($34, Market Perform) and TDC ($43, Underperform) have been blamed on the macro. While we believe this to be the case, we also believe these macro issues are accelerating a technology transition from legacy products to alternative data management systems as users are increasingly evaluating products like Hadoop that offer compelling functionality at materially lower price points. While a user’s motivation for an initial Hadoop deployment may be cost, end users we talked to spoke of incremental outcomes around better flexibility and functionality that enabled broader value-added use cases to support the business.

Transitional vs. Transcendent

From our perspective, there are two primary use cases for Hadoop, the first is transitional, the second is transcendent. Hadoop is replicating legacy processes in a lower cost model, this is transitional. Hadoop is also creating brand new business opportunities based on data that can only be leveraged when enabled by a new data management technology platform. This is transcendent. We believe both of these opportunities are happening in parallel and at very different rates of adoption, and both are in their very early days.

Big, Bigger, Biggest Opportunities

We believe Hadoop is a big opportunity and we can envision a small number of billion dollar companies based on Hadoop. We think the bigger opportunity is Apps and Analytics companies selling products that abstract the complexity of working with Hadoop from end users and sell solutions into a much larger end market of business users. The biggest opportunity in our mind, by far, is the Big Data Practitioners that create entirely new business opportunities based on data where $1M spent on Hadoop is the backbone of a $1B business. Please see addendum of this report for important disclosures.
Notes from Hadoop World

We recently spent time at Hadoop World, Cloudera’s annual user conference. We continue to believe that Hadoop and its ever-growing ecosystem of partners are disrupting the legacy order at an accelerating pace. The legacy providers of data management systems have all fallen on hard times over the last year or two, and while many are quick to dismiss legacy vendor revenue shortfalls to macroeconomic issues, we argue that these macroeconomic issues are actually accelerating a technology transition from legacy products to alternative data management systems like Hadoop and NoSQL that typically sell for dimes on the dollar (please see our recently published note entitled “How Much Cheaper are Lower Priced Competitors? You May Be Surprised”).

We believe these macro issues are real, and rather than just causing delays in big deals for the legacy vendors, enterprises are struggling to control costs and are increasingly looking at lower cost solutions as alternatives to traditional products. What we are gleaning from multiple conversations with users of these new technologies is that regardless of the initial reason they experiment with these new technologies, the outcome is 1) The realization that not only are these products cheaper, but they are more flexible and better suited to many legacy workloads and 2) They offer end users the optionality to expand project scope beyond the constraints associated with legacy product, whether those constraints are cost or capabilities.

What inning are we in?

The question on everyone’s mind is how far along are we in the adoption of new data management tools. From our perspective, we are in the third round… of the draft. There are a TON of very well-funded Big Data startups that are being told to get big or die trying, and more concepts are getting funded every day. While there are some stand outs in the field that have gotten the lion’s share of attention (Cloudera, Hortonworks, 10Gen, DataStax etc.), it is way too early for anyone to claim victory or for investors to pick any specific vendor as a clear winner.

Right now anyone using Big Data technology has to sift through a tremendous amount of marketing noise, and then cobble together a patchwork of technologies around data management, integration, analytics, etc. to piece together a workable solution. All that is easy compared to the task of finding people capable of using these new technologies. All of this is done against the backdrop of customer concerns around vendor viability and the ever present threat of a legacy vendor buying the startup whose technology they are using and then jack prices up. While we firmly believe that the open source nature of these new data management technologies and the relatively rock bottom prices for these cutting edge products are a material deterrent to potential acquisitions from legacy vendors, these concerns still represent a barrier to adoption. All of this to say, while this market is promising, it still has a huge way to go before it gets anywhere close to mainstream.
Transitional vs. Transcendent

Investors often confuse transitional technology trends with transcendent technology. Two examples illustrate this point.

1. In 1994 when CDNow first came on the scene, people were amazed at the brilliance and “can’t lose” opportunity to buy compact discs from a website instead of driving to a record store. It was a great idea to replicate a storefront on the internet and it helped consumers transition from buying physical media in a store to buying it online. When Apple launched the iPod in 2001, it transcended the music buying paradigm and fundamentally changed the way we buy music. Why buy 1) Physical media and 2) A bunch of songs you don’t want.

2. When the first Blackberry came to market in 1999, it was a technology miracle. This little brick meant access to email was available 24/7 and parents could start ignoring their kids around the clock without the burden of logging into email via slow and unreliable dial up connections. It was a can’t-miss idea and the investment opportunity of a lifetime. The Blackberry was a transitional email device that got people comfortable with an always on always available mobile device. When Apple launched the first iPhone in 2007, it transcended mobile email by offering mobile device carriers the opportunity to have a limitless supply of functionality (ed. note: I deliberately didn’t use the word productivity…) at their fingertips.

So what does this have to do with Hadoop? From our perspective, there are two primary use cases for Hadoop, the first is transitional, the second is transcendent. Hadoop is replicating legacy processes in a lower cost model, this is transitional. Hadoop is also creating brand new business opportunities that can only exist when enabled by a new technology platform. This is transcendent. We believe both of these opportunities are happening in parallel and at very different rates of adoption. Hadoop as a lower cost legacy process is transitional. Hadoop as an opportunity creator is transcendent.

We view companies like Google, LinkedIn, Twitter and Facebook as transcendent companies. These companies could not have existed without new data management technologies. But these kinds of companies are far fewer in count or significance than the large handful of F5000 companies that are cutting their teeth on Hadoop in a familiar and non-threatening transition exercise; cost cutting. It is our belief that as users start using Hadoop and build critical skill sets around the technology, we will see internal developers start to work more closely with product departments, and together they will find ways to disrupt legacy markets or create entirely new opportunities.

In our coverage universe, we believe Intuit (INTU $71, Outperform) and Constant Contact ($27, Outperform) are the two best examples of this opportunity. Both of these companies have essentially all of their customer interactions on line, and are collecting enormous data sets to not only manage the existing business better, but also look for new ways to monetize
relationships. We believe these big data practitioners are the best fundamental investment stories in our coverage universe.

Big, Bigger, Biggest

As we have stated before, we see three categories of winners in Big Data.

➤ The Big category of winners is the infrastructure providers like the Hadoop vendors and the NoSQL vendors. These are critical enabling technologies and the winners here have very bright futures as we believe these are the technologies companies will build businesses on for decades to come. However, no one buys core technology unless $1 spent on core technology delivers multiple dollars in return.

➤ The Bigger category of winners are the Apps and Analytics vendors that abstract the complexity of working with very complicated underlying technologies into a user friendly front end. The addressable audience of business users is exponentially larger than the market for programmers working on core technology. Importantly, over time, apps that just automate processes are a commodity. We believe that next gen apps will embed data to give processes context, and the value is in the data, not the automation.

➤ The Biggest category of winners is the Big Data practitioners. These are the business people that have identified opportunities to use data to create new opportunities or disrupt legacy business models. We think this opportunity is so profound, we believe that the dividing line between winners and losers in the business world over the next decade will hinge on a company’s ability to leverage data as an asset.
Valuation Methodology & Investment Risks

Valuation Methodology

Software:

Our valuation methodology is primarily based on Enterprise Value to Free Cash Flow (EV/FCF), followed by Price-to-Earnings (P/E). However, this varies by company; for instance, we will often use Enterprise Value to Revenue (EV/Revs) for application software companies that are primarily subscriptions-based, or for growth companies that have recently entered the public equity markets.

Investment Risks

Software:

The global economy or specific end markets significantly worsen, contracting IT spending and impairing infrastructure software growth. The rate of SaaS/Cloud adoption slows, resulting in prolonged sales cycles and higher-than-anticipated quarterly volatility across much of our coverage universe. Competition increases materially, driving deflationary pricing pressure and compressing margins. In particular, innovation by new entrants in the software sector often produces solutions with similar or better functionality at materially lower prices than incumbents’ legacy offerings.
Addendum

STOCKS MENTIONED IN IMPORTANT DISCLOSURES

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Cowen and Company Rating System effective May 25, 2013
Outperform (1): The stock is expected to achieve a total positive return of at least 15% over the next 12 months
Market Perform (2): The stock is expected to have a total return that falls between the parameters of an Outperform and Underperform over the next 12 months
Underperform (3): Stock is expected to achieve a total negative return of at least 10% over the next 12 months
Assumption: The expected total return calculation includes anticipated dividend yield

Cowen and Company Rating System until May 25, 2013
Outperform (1): Stock expected to outperform the S&P 500
Neutral (2): Stock expected to perform in line with the S&P 500
Underperform (3): Stock expected to underperform the S&P 500
Assumptions: Time horizon is 12 months; S&P 500 is flat over forecast period

Cowen Securities, formerly known as Dahlman Rose & Company, Rating System until May 25, 2013
Buy – The fundamentals/valuations of the subject company are improving and the investment return is expected to be 5 to 15 percentage points higher than the general market return
Sell – The fundamentals/valuations of the subject company are deteriorating and the investment return is expected to be 5 to 15 percentage points lower than the general market return
Hold – The fundamentals/valuations of the subject company are neither improving nor deteriorating and the investment return is expected to be in line with the general market return

COWEN AND COMPANY RATING ALLOCATION
Distribution of Ratings/Investment Banking Services (IB) as of 09/30/13

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(a) Corresponds to "Outperform" rated stocks as defined in Cowen and Company, LLC’s rating definitions. (b) Corresponds to "Market Perform" as defined in Cowen and Company, LLC’s ratings definitions. (c) Corresponds to "Underperform" as defined in Cowen and Company, LLC’s ratings definitions.

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Rating and Price Target History for: Constant Contact (CTCT) as of 11-04-2013