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## Constant Contact (CTCT—$16)

Outsourced email and online marketing services are a proven but very competitive market. After looking at the Constant Contact (CTCT) business and financial model it's clear that stock appreciation from these levels depends on a very optimistic view of company operations in the next few years. We forecast increasing rivalry in this industry segment, and our valuation models suggest a maximum company value of $14/share.

CTCT went public on October 2, 2007, at $16 per share. Since then it has traded in a range of $16 to $26. We first recommended it as a short in October 2007 at $24 and are back with more analysis prior to major share lock-ups coming off in March. We've looked at the offerings in this market as both an investor and a business user and make the following observations:


**Figure 1**—CTCT Stock Performance

1. Investors love CTCT. We were surprised to see the excitement around the CTCT offering and shocked to note that the company presentation to investors made little mention of losses but instead focused on customer economics and gross margins. The appetite for Software as a Service (SaaS) companies in the public market remains high and may explain not only the enthusiasm for CTCT but also for NetSuite.

2. CTCT has the potential to be a decent business. The market that CTCT serves is well suited to using online marketing services rather than building them in-house. Because customer communication and marketing is so essential the market is indeed large. We're willing to agree that the market size is a few billion dollars per year. Given that figure it suggests that CTCT and other market players will continue to grow.

3. CTCT doesn't have the potential to be a great business. The core of the problem here is that there are many players in this market, and there have been for a long time. History has proven that the margins on this business are low. See the competition section of this report for examples of the many similar players in the market and the dynamics of switching vendors or substituting other technology for email services.

4. Generous assumptions don't provide any upside. We ran our long-term valuation model and granted the company the revenue growth and margin expansion they might be able to achieve. Fair valuation varies based on the eye of the beholder. We used EBITDA margins consistent with Salesforce.com, applied a 30x multiple to 2011 earnings and discounted by our standard 15% to arrive at the $14 price target.

5. Additional shares are coming off lock-up. On March 2, 2008, more than 15M shares are scheduled to come off lock-up. It's likely that the company will announce an organized secondary offering that could limit additional supply if done properly. But we still expect the market-clearing price to be below current levels. The stock is already heavily shorted, which is a demand risk.

We think CTCT is a decent company in a good market. However, it's not one that is likely to generate very high returns based on its positioning and competition. Many similar companies exist, and those that have been marked to market recently support a much lower valuation view for CTCT as well.

## The company in brief

CTCT was started back in 1995 under the name Roving Software, and moved to the online model along the way. Today it provides an outsourced email solution targeted at the small business and non-profit market. Clients can easily create, execute and manage email-based marketing programs for a small monthly fee. Prices start at $15/month and scale up based on usage. The company has more than 150,000 customers who are paying an average of $33/month.
The company has produced the steady and predictable revenue growth that investors find hard to resist. The growth rate has been 80% to 90% annually. We expect the company to report full year results of around $50M when it reports its Q4 results, which ended December 31, 2007, on February 20, 2008. (Why it takes an on-demand company so long to report results we don't know.)

For investors, the returns hinge on both the customer and company economics of the business model. Management presents customer economics that are very attractive taken at face value. According to management, a CTCT customer generates $1,485 of lifetime revenue and costs $300 to acquire. Overall the numbers presented are reasonable except for the 45-month customer life. This seems a bit long to us as an assumption. However, the customer economics still work at smaller values of customer duration.

A similar analysis back in the days of the Vonage IPO yielded similarly attractive customer economics. But it still takes a company to drive the business forward with the associated costs. Management takes some liberties to come up with an "adjusted" EBITDA that is positive on a quarterly basis today and promises to be so for the full year 2008. However we're more interested in the long-term EBITDA margin potential.

The following slide from a recent management presentation (January 9, 2008) is worth examining. Although the gross margin and R&D expense targets might be a trifle aggressive, it's the figure for sales and marketing that steals the show. After increasing more than 6 percentage points in the first nine months of 2007, management suggests that these costs **will fall by 25 percentage points** to yield its outlandish target model of 17–19% operating margins and 24–26% "adjusted" EBITDA margins.

Financial Highlights

Constant Contact

| ($ in thousands) Year Ended Dec 31Long | FY 2005 | FY 2006 | Quarter Ended 9/30/07 | YTD 9/30/07 | Long-term Target Model |
|---|---|---|---|---|---|
| Revenue | $14,658 | $27,552 | $13,517 | $34,628 | 100% |
| Gross Margin | $10,911 74.4% | $19,751 71.7% | $10,094 74.7% | $25,368 73.3% | 72 - 74% |
| Research & Development | $3,355 22.9% | $6,172 22.4% | $2,536 18.8% | $7,507 21.7% | 12 – 14% |
| Sales & Marketing | $7,460 50.9% | $18,592 67.5% | $6,742 49.8% | $19,537 56.4% | 31- 33% |
| General & Administrative | $1,326 9.0% | $2,623 9.5% | $1,597 11.8% | $3,968 11.5% | 9 – 11% |
| Operating Loss | ($1,230) (8.4%) | ($7,636) (27.7%) | ($781) (5.8%) | ($5,644) (16.3%) | 17 – 19% |
| Adjusted EBITDA (1) | ($622) (4.2%) | ($6,017) (21.8%) | $104 0.8% | ($3,415) (9.9%) | 24 – 26% |
| Number of Customers | 47,730 | 89,323 | 145,067 | 145,067 | |

(1) Calculated by adding stock-based compensation and depreciation and amortization back to operating loss.

**Slide 1 – Company target model as presented by management.**

Over time the company expects to add additional functions, such as the recently-added survey capability, and may make acquisitions to expand its set of offerings.

## Competition

In this section we'd prefer to let the pictures do the talking. It's true that traditional email systems don't provide the level of tracking and feedback that online solutions do. So for now we will leave those out of the mix. However, in time we expect them to add these capabilities to their offerings. Turning to the companies that provide the same type of on-demand email and online marketing services as CTCT one can see there is plenty of choice in the market. Figure 2 illustrates the current pricing grid for CTCT. The grid also illustrates the company strategy of adding products to increase average revenue per customer.

| Your Email List Size | Your Low Monthly Fee | | |
|---|---|---|---|
| | Email Marketing* | Survey** | Bundle** |
| 0-500 | $15 | $15 | ~~$30~~ $22.50 |
| 501-2,500 | $30 | $30 | ~~$60~~ $45.00 |
| 2,501-5,000 | $50 | $50 | ~~$100~~ $75.00 |
| 5,001-10,000 | $75 | $75 | ~~$150~~ $112.50 |
| 10,001-25,000 | $150 | $150 | ~~$300~~ $225.00 |
| 25,000+ | Call for Special Pricing | | |

**Figure 2**—Constant Contact pricing grid

It doesn't take more than an afternoon to sort through the 20 to 30 odd competitors and identify the four or five that are close fits. In fact, they are basically all doing the same thing as CTCT. There are minor differences in functionality and a fairly wide range in the quality of customer support. Figure 3 illustrates the pricing grids from a few such competitors. There are several others that are not illustrated but which are similar.

**Standard Plans**

The Standard Plans offer affordable e-mail marketing for firms that expect to send up to 100,000 e-mails per month.

| PLANS | EMAILS PER MONTH | ADDITIONAL PER 1,000 | |
|---|---|---|---|
| Free (30 day trial) | 200 | N/A | Sign Up |
| $5.95/mo | 500 | $5.00 | Sign Up |
| $19.95/mo | 10,000 | $2.00 | Sign Up |
| $29.95/mo | 20,000 | $1.50 | Sign Up |
| $49.95/mo | 50,000 | $1.00 | Sign Up |
| $79.95/mo | 100,000 | $0.80 | Sign Up |

| Contacts | Monthly | Annual |
|---|---|---|
| 500 | $9.95 | $107.46 |
| 1,000 | $14.00 | $151.20 |
| 2,500 | $29.00 | $313.20 |
| 5,000 | $47.00 | $507.60 |
| 10,000 | $74.00 | $799.20 |
| 15,000 | $109.00 | $1,177.20 |
| 25,000 | $149.00 | $1,609.20 |
| 35,000 | $239.00 | $2,581.20 |
| 50,000 | $379.00 | $4,093.20 |
| 75,000 | $529.00 | $5,713.20 |
| 100,000 | $699.00 | $7,549.20 |

| Your Email List Size | Monthly | Non-profits |
|---|---|---|
| 0-500* | $15 | $12.50 |
| 501-2,500* | $30 | $25.50 |
| 2,501-5,000* | $50 | $42.50 |
| 5,001-10,000* | $75 | $63.75 |
| 10,001-25,000* | $150 | $127.50 |

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| | |
|---|---|
| 1,000 emails a month | $30 |
| 2,500 emails a month | $45 |
| 5,000 emails a month | $70 |
| 7,500 emails a month | $100 |
| 10,000 emails a month | $125 |
| 17,500 emails a month | $170 |
| 25,000 emails a month | $210 |
| 37,500 emails a month | $280 |
| 50,000 emails a month | $350 |
| 75,000 emails a month | $480 |
| 100,000 emails a month | $600 |
| larger volumes | custom pricing |

**Figure 3**—Pricing grids from Constant Contact competitors MailChimp, Emma, StreamSend and iContact

## Switching costs are low

Just because there are many similar offerings in the market doesn't mean that customers will switch. However, these companies use as many standard elements to deliver their functions. This means that moving from one vendor to another can be accomplished in as little as one day. A simple export of the customer lists from one system and an import into another is all one need do on the customer side. Past campaigns would certainly require some tweaking if they were to be used again or simply redesigned. We've moved through about half-dozen of these offerings in both hosted and non-hosted situations and can attest to the ease of movement.

Many of the vendors today offer nearly unlimited 30-day free trials, so it's even possible to use competitive systems for free. Individual software products also work fairly well if detailed link tracking isn't needed and can be had for as little as $29.

The main point to seeing competition for what it is and recognizing that switching can be done easily and often for reduced prices suggests that customer duration assumptions of 45 months may be optimistic. Small upward movement in customer acquisition and support costs combined with shorter average customer life can severely impair returns.

## Valuation

Today CTCT trades at a valuation that is average for the SaaS group of companies we track. That translates to slightly more than 6x 2008 revenues and more than 100x 2009 earnings estimates. There's probably an argument for group valuations to come down somewhat on average, but each company has different competition and market positions. As usual, we revert to our more fundamental view of valuation looking at the long-term. In the case of CTCT we feel that we have been generous in terms of revenue growth and EBITDA margins. Our growth numbers are ahead of where consensus estimates are currently, and we allowed EBITDA and operating margins that are equal to market-leading Salesforce.com. Even with all that optimism we still end up with a $14/share valuation. All the numbers and analysis below is based on a near-best-case scenario. Even a modest revision downward would push fair value down to the $10-12 range.

| **Constant Contact** | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| Revenue | $25 | $50 | $90 | $165 | $248 | $347 |
| YoY Growth | | 100% | 80% | 60% | 50% | 40% |
| EBITDA Margin | -10% | -5% | 4% | 6% | 8% | 10% |
| Taxed Operating Net | -$2 | -$2 | $2 | $6 | $13 | $23 |
| Projected Market Value | -$49 | -$49 | $70 | $193 | $386 | $676 |
| Shares (M) | 27 | 28 | 30 | 31 | 33 | 34 |
| Projected Price/Share | | -$2 | $2 | $6 | $12 | $20 |
| Present Value of 2011 | | $386 | | | | |
| Current Cap/Earnings | -332 | -332 | 231 | 84 | 42 | 24 |
| Current Cap/Revenue | 22 | 11 | 6 | 3 | 2 | 2 |

| **CTCT** | |
|---|---|
| 66% | Growth |
| 5% | Avg. Dilution |
| 30 | P/E Multiple |
| 27 | Shares Out |
| **$20** | Current Price |
| $540 | Cap (M) |
| 15% | Discount Rate |
| **$14** | Target Price |

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