

MII SHORT FUND ELECTION MEMO – SALESFORCE.COM

TO: MII Managers
FROM: Hunter Armistead, Sector Head and Analyst, MII
 Second Year, Majors: Commerce and Economics
SUBJECT: Salesforce.com, Inc. (NYSE: CRM)
DATE: April 27, 2008



Selected Financial Metrics:

Stock Data

Market Capitalization	8.04B
Trailing P/E Ratio	449.53
Forward P/E Ratio	105.36
Price / Free Cash Flow	45
Dividend Yield	0.00%
Latest Dividend	\$0.00
Average Volume 10 day	2,007,530
Average Volume 3 month	1,961,540
Shares Outstanding	119.3M
Public Float	77.7M
Enterprise Value / Sales	10.16
Beta	3.31

Short Interest

Total on 03/26/08:	8.28M
Total Shares for Previous Month:	7.93M
Short Interest Ratio ¹	4.7
Short Interest as % of Public Float	10.7

¹= (Short Interest / Average Daily Trading Volume). Number of days of average daily volume needed to close out total short position. Ratio of 5 or greater can be taken as a bearish / pessimistic symbol. Others think a high ratio could indicate a bullish attitude if a short squeeze were to occur, but this situation is fairly rare and hard to predict.

QuickTime™ and a
decompressor
are needed to see this picture.

52wk Range: 37.24 - 69.65

Business Description:

Sector: Technology, Internet Software and Services

Salesforce.com was founded in 1999 by former Oracle executive Marc Benioff. The company had its IPO in June 2004 and is listed on the New York Stock Exchange. The company is headquartered in San Francisco and has offices around that world. Salesforce.com provides on-demand customer relationship management (CRM) services to businesses and industries across the globe.

Salesforce.com's CRM services allow subscribers to systematically record, store, analyze, and act upon business data. Their services also help businesses manage customer accounts, track sales leads, evaluate marketing campaigns, and provide post-sales service. The company's Salesforce suite of on-demand CRM applications allows customers to manage and share all of their sales, support, marketing, and partner information on-demand. The Salesforce Platform enables customers, developers, and partners to build powerful new on-demand applications that extend beyond CRM to deliver the benefits of multi-tenancy and The Business Web across the enterprise. The Salesforce Platform allows applications to be shared, exchanged and installed via Salesforce.com's AppExchange directory. Large cap, mid cap, and small cap companies each contribute approximately 1/3 of the company's total sales revenues.

Products:

Salesforce.Com services mainly focus on the following functional areas within CRM:

Sales force automation, marketed under the brand Salesforce SFA, enables salespeople to

automate manual and repetitive tasks and provides them with data about current and prospective customers. For example, Salesforce SFA helps salespeople manage sales opportunities, leads, forecasts, processes, and closed business by territories.

Partner relationship management, marketed under the brand Salesforce PRM, provides channel managers with complete visibility into their company's entire sales pipeline for direct and indirect channels. Salesforce PRM allows partners to access leads, collaborate on deals, and house information centrally.

Marketing automation, marketed under the brand Salesforce Marketing, enables companies to manage marketing campaigns from initiation to lead development to sales. The application can measure the effectiveness of each campaign by quantifying the revenue generated as a result of specific marketing activities.

Customer service and support automation, marketed under the brand Salesforce Service & Support, allows companies to interact with existing customers for a variety of service and support needs, such as requests for repairs, advice about products and services, complaints about faulty goods, and the need for additional goods and services. Using this product, customers can create a virtual contact center to support a wide range of customer interactions through voice, chat, email, and in-person interactions.

Thesis Points:

Unsustainable Growth due to Low Barriers to Entry and Increased Competition

Salesforce.com has grown substantially over the past 7 years (see graph). Salesforce.com revenues rose at a compound annual growth rate (CAGR) of nearly 112% from FY 01 to FY 07. The company's EPS growth (Quarterly, year-over-year) of 1302.2% and long-term growth rate (5 years) of 47.62% are the highest in the entire Internet and Software Services industry. In Q4 of 2007, the company reported the following measures of growth:

- Revenue of \$217 Million, up 50% year-over-year
- Operating Cash Flow of \$181 Million, up 112% year-over-year
- Net increase in customers from 11,200 to 41,000 year-over-year
- Company raised FY09 revenue guidance to \$1.030 - \$1.035 Billion

EPS forecasts are \$0.15, \$0.32, and \$0.62 for 2008, 2009, and 2010, respectively. The company has projected revenue growth of 49% over the next year, which, along with its other high expectations, will be extremely difficult to meet given the new competitors in the web-based application market. Newly public Netsuite (NYSE:N) and SuccessFactors (NYSE:SFSF) develop and market software similar to that of the Salesforce.com. SuccessFactors was initiated last month by Pacific Crest Securities with a rating of Outperform, who called the two-million-user firm "the world's largest on-demand application provider." There are more competitors on the way, including Varolii, whose software automates collection agencies' calling process, and Convio, whose customer-relations software targets nonprofit organizations. Traditional mid-tier software companies like Maximizer have also responded to market pressures with very competitive pricing, increasing pressure on the bottom line of Salesforce.com. CRM growth is also expected to slow in the U.S. because a lot of early adopters are already using CRM applications. One of the big reasons for Salesforce.com's

success, their low barrier to entry, is also a major risk to the company's success and future growth. It allows competitors to easily enter into the market and take potential and existing customers and revenues from Salesforce.com. With so many alternatives to choose from, outages and customer service problems can cause customers to make the switch to another provider. Salesforce.com experienced an outage in late 2005 and then early 2006 that lasted over a day, which shows the company's vulnerability to such a risk. This cut off thousands of customers from vital business data needed to conduct daily operations. With the low barriers of entry, the lofty projected growth for Salesforce.com will most likely not be met.

QuickTime™ and a
decompressor
are needed to see this picture.

Strength of Large Competitors

With a growing global CRM market, big competitors have taken steps to further challenge Salesforce.com's growth and profitability. On April 22, Microsoft announced the general availability of Microsoft Dynamics CRM Online. It will initially be packaged into two service offerings: Microsoft Dynamics CRM Online Professional and Microsoft Dynamics CRM Online Professional Plus. This move by Microsoft will most likely not immediately affect Salesforce.com, but rather shape the marketplace for the next several quarters. Microsoft has entered the software as a service market with a competitive product carefully and deliberately, making sure it has worked out the service component prior to this announcement. More than 500 customers and 200 partners have used Microsoft Dynamics CRM Online over the past six months and its interface, which is very similar to Outlook, will probably lead to faster uptake and adoption. One of the main implications for Salesforce.com is that Microsoft offers their CRM products at a lower price. The Professional Edition is priced at \$44 a month (with an introductory offer for \$39 a month) and the Professional Plus Edition is \$59 a month. Though there are reports that Microsoft's offering isn't as feature-rich as the one from Salesforce.com, Salesforce.com's starting price point is around \$65. Oracle and SAP are also large competitors in the SaaS market and, like Microsoft, increase pressure on margins and hinders Salesforce.com from meeting growth expectations. They also have more funds to spend on R&D, which gives them a huge edge over Salesforce.com in developing differentiable and superior products. All of the competition, both large and small, means Salesforce.com's days of exclusivity and rich premiums are numbered.

Insufficient Investment in R&D to Differentiate Products from Competitors

Over the past few years, Salesforce.com has been experiencing declining R&D expenditures as a percent of sales. With all of the new competitors in the market and the increasing commodification of the sales and service products, R&D is paramount in importance for delivering differentiated and technologically superior products. Marketing costs are currently Salesforce.com's biggest expenditures (50% of revenues), and the huge increase in competition in the SaaS market will most certainly drive these costs even higher. Salesforce.com currently spends roughly 6 times more on marketing than R&D (\$253 million compared to \$44 million). With increased marketing costs and pressures on margins, R&D costs will most likely suffer as well. This will lead to a decreased rate of innovation that will possibly subject the company's products to technically superior ones.

High Multiples and Overvalued Stock

Salesforce.com's stock is currently trading at a significant premium to the group, trading at Price/Free Cash Flow of 45, significantly above the overall sector's median multiple of 17. The company's P/E ratio of 450 is also the highest in the industry. The company is so highly valued that if there were the slightest misexecution by management or any unforeseen obstacles, the stock price would most likely take a huge hit. I do not believe that the stock properly values the risks of the SaaS business, and that the risk/reward remains to the downside. Having our current economic environment with lengthening sales cycles and intensifying scrutiny of software budgets, coupled with the huge increase in competition, makes me believe that this presumptuous multiple will come back to haunt Salesforce.com in the future and drive their stock price down significantly.

Risks:

Alliance with Google

Recently, Salesforce.com has entered into a global strategic alliance with Google to include the ability for customers to run Google Apps fully integrated with Salesforce.com applications under the new offering Salesforce for Google. I do not think this announcement to have a significant impact on Salesforce.com's top or bottom lines for the time being, as analysts report Salesforce for Google Apps to be of interest, at least initially, for just small and medium sized businesses. I do not doubt, however, that Google and salesforce.com will add depth and increased functionality to this offering over time. While the enterprise applications market is highly competitive and not exactly complementary with Google's core businesses, Google is slowly moving in this direction first with the development of Google Apps and now with its integration with Salesforce.com. There could be a closer relationship between the two companies in the long term, or Google could terminate the relationship and compete on their own. Again, the revenue and earnings impact from this alliance is expected to remain fairly limited over the foreseeable future.

Expansion / Development of Services Superior to Competitors

If Salesforce.com's continues to execute on the SaaS opportunity faster than all of its competition, it could meet earnings expectations. However, I do not think that the company has any significant competitive advantage that would allow this to happen. As mentioned earlier, the products in the SaaS industry are becoming less and less differentiable, so pricing is one of the most important ways to distinguish between products. With little investment in R&D, especially compared to their bigger

competitors, I think that Salesforce.com has little chance of producing any groundbreaking innovations within the industry.

Potential Acquisition

Though there are currently no talks taking place at the moment, Salesforce.com could be acquired by a large Internet company or software vendor in the future. I do not think that is much of a risk right now, but it could become more of one in the future.

Loyal Customer Base

Being one of the first companies in the SaaS market, customers of Salesforce.com could be loyal to the Salesforce.com brand name. Salesforce.com has attracted nearly one million subscribers and continues to grow. If the price differences are not too large between Salesforce.com's products and those of its competitors, customers could choose to stay with the CRM applications from Salesforce.com. I think this possibility is unlikely, however considering that Microsoft has just entered into the market and consumers are much more familiar and comfortable with their software, not to mention it is offered at a lower price. I think that especially in a down-turning economy, customers will favor the most efficient, inexpensive product, and will not be loyal to Salesforce.com.

Value-Added Research:

Pat Walravens, Analyst Covering Salesforce.com, JMP Securities (Neutral Rating)

- Google will take some time to develop enterprise products, mostly for personal use
- Most analyst and business documents are in Word or Excel
- SuccessFactors is not too big of a threat for Salesforce.com
- Netsuite is something to worry about
- Salesforce.com has lots of room to miss estimates

Sasa Zorovic, Analyst Covering Salesforce.com, Goldman Sachs (Sell Rating)

- Does not see partnership with Google having effects on Salesforce.com for a while
- Salesforce.com is trading at an extremely high multiple that leaves little room for error
- Microsoft entering market will not have immediate effect on Salesforce.com, but will be powerful competitor in future
- Current economic situation is poor, leading to more scrutinizing of software budgets
- Risk that Salesforce.com could be bought

Marc Ferguson, President, Nets to Ladders

- Used Microsoft CRM to create Benefits Enrollment Network for H&R Block
- Microsoft Dynamics CRM brings business process automation to an otherwise complex, multi-step process
- Thinks Microsoft has great products for CRM
- Microsoft Dynamics CRM provides a familiar interface that works the way Microsoft works, which is the way the world works with computers.
- Microsoft Dynamics CRM provided a solution that could realistically be provided to nonprofit organizations, hospitals, schools, employers, and others.

Zachary Scheidt, Managing General Partner, Stearman Capital

- Salesforce.com has extremely high multiple
- Difficult to imagine a scenario where Salesforce.com would offer an upside to the current expectations
- Any disappointing news could have a devastating effect on the stock price
- Salesforce.com is having a difficult time maintaining its market value
- Company will likely have to spend a decent amount to open new data centers in these new areas which will cut into margins

Summary:

After evaluating the risks and benefits of shorting Salesforce.com, I would strongly recommend shorting the stock. The stock is valued to perfection, leaving no room for error by management or for successful competitors. The projected growth for the company seem to overlook a lot of the risks that the company will have in the future, especially with large competitors that have proven successful in the software industry. My VAR supported my thesis points, and nearly each one of them commented on how high the stock is currently valued. I think a good entry point would be right before the Q3 earnings report, which would give Microsoft more time to grow within the industry.

Ideas for MII:

I think that MII has taken a lot of very good steps in improving the club over the past two years that I've been a member. I like how the communication has improved between the managers and the other members of the club, particularly concerning the selection of stocks. I think one way to improve MII would be to publish the Sector Head reports on the website. It would give members a good snapshot of lots of different industries, and it could also inspire people to look into the short and long ideas proposed in each report. I think that it might also be fun to have an alumnus from Wall Street who was in MII come back and talk to us about his work once a semester. One thing I noticed when I was doing this report was that it is extremely hard to get in touch with analysts, and it took multiple attempts with each of my contacts. I think that it would be great to network with MII alumni that would be willing to answer VAR questions for reports every now and then, and then compile a list and make it available to the club. I think that taking a trip (rather somewhere close by like Richmond or somewhere far away New York) to see a venture capital firm, investment bank, etc. would also be a great experience for members.