3 New Tech IPOs, Explained

Description

The past month has seen three under-the-radar tech companies go public. In this episode of *Industry Focus: Tech*, host Dylan Lewis and analyst Joey Solitro dive into **SmileDirectClub** (NASDAQ: SDC), **Datadog** (NASDAQ: DDOG), and **Cloudflare** (NYSE: NET).

Tune in to learn what each business does; why SmileDirectClub is tech-y enough to warrant some time on this show; how the financials look for these three; how investors can tell all these similar-sounding software-as-a-service companies apart and really figure out who's best in class; what risks to keep an eye on, especially with Cloudflare; some general rules of thumb for long-term IPO investing; and more.

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Dylan Lewis: Welcome to *Industry Focus*, the podcast that dives into a different sector of the stock market every day. It's Friday, September 20th and we're talking about some fairly new publicly traded companies. I'm your host Dylan Lewis, I've got premium analyst Joey Solitro with me in the studio. Joey, what's been going on, man? You've been all over the place the last couple weeks. Podcasts, YouTube lives. I don't know how you're doing it.

Joey Solitro: My companies are all the rage these days so I'm getting some extra attention. I'm loving it. As long as IPOs and SaaS stay in focus, I'll be here.

Lewis: We're happy to have you here. We're going to be talking about some tech companies, some ones that you follow. If folks are interested in the SaaS space, you did that YouTube Live a couple weeks back with Chris and Jason Moser. That exists over on the YouTube channel, in case people want to check that out.

Solitro: Check it out.

Lewis: Check it out. We're talking about three companies today that have gone public in the past month, which is kind of wild. People tend to really pay attention to the IPO calendar when the big names go public — the **Lyft**s, **Uber**s, **Pinterest**s of the world. The reality is, companies are going public all the time.

Solitro: Yeah, I wish people would stop paying so much attention so I could get a decent valuation here and there. But I'll take them when I can get them.

Lewis: [laughs] We're going to cover these in chronological order. We've got Smile Direct, Cloudflare, and Datadog. Definitely three companies that we're going to have to explain a little bit. They don't have the brand name recognition of some of the other IPOs we've talked about in the past. Let's talk about Smile Direct Club first.

Solitro: I'm sure a lot of people know the Invisalign brand for braces. What these guys have done is, Invisalign is actually a supplier of theirs, where they're going direct to consumer with these. They'll have their mold kits, or you can go into one of their Smile shops. They actually have partnerships with **CVS** and **Walgreens**, so they're going to start popping up in there. And basically, they take a scan, or they take this mold of your teeth, they ship it to their orthodontists over in Costa Rica, and they create this plan. And then it comes back to a local orthodontist near you that says, "Yeah, they're a candidate for this. Let's give them the green light to go." And then within three to four weeks, you have your new, clear aligners.

The cool thing about them is, they're reducing the cost of doing this. I was doing some research, and traditional braces, whether metal or through Invisalign, is $5,000 to $8,000. Smile Direct is $1,895. They broke it down below $2,000, and you're going to be wearing these for five to 10 months instead of 12 to 24 months. Shorter time, less money, you don't have to waste your time going to the orthodontist 10 to 15 times. It's just a great business model. The growth is real with this one.

Lewis: The way that I think about this one is Warby Parker, but for teledentistry.

Solitro: Exactly.

Lewis: They made their money, and they really got into a market, by saying, "We can cut out a lot of the costs that come with eyewear. We don't need all these flashy retail locations." They ultimately decided to do that. But for a while, they were saying, "We're going to cut all that stuff out, we're going to bring the cost down, because we're doing a direct to consumer model and we don't have nearly as much overhead as some of the other guys out there." That's what Smile Direct has done. The difference is, they're doing it with dentistry.

Solitro: Pretty much, yeah. If you own your supply chain, you can completely reduce the cost. You could go to an orthodontist who buys materials from this person, or has this person make their braces or their aligners. Or, you can go to this one company that cut out a lot of the fat, reduced the costs, and it's going to come directly to you.

Lewis: You mentioned the growth. There are some pretty staggering numbers if you look at the financials. They were up 184% year over year in 2018, over 100% year over year growth in revenue the past two quarters. It seems like this concept is catching on. When you come into the marketplace at a lower price, people tend to pay attention.

Solitro: The other thing, on top of the very impressive growth, gross margin over 75%. I was not expecting that. I thought, based on this growth and what they're doing, they're probably under 50%. I was shocked. And then you see they're aiming for I think was 80% to 85% gross margins long-term. That's not that much of a stretch.

Lewis: Some other stuff that I really like with this business — people might be surprised that we're talking about it on a tech show, because this is, in some ways, a consumer goods company. But ultimately, the reason that they're able to offer these lower prices is, they've figured out a more integrated system to make all this happen. I'm going to give them a tech check because of that. You look at what they have in terms of inventory, it's tiny. They have very little inventory given what they do in sales. $13 million in inventory at the end of a period where the company did almost $600 million in trailing 12-month sales. You don't see that too often for anything in the consumer goods space.

Solitro: No. That's one thing I don't play with — I don't like companies with inventory. I love my SaaS companies. If you have a product housed and you have to sell it, and it becomes this toxic inventory, it's just something I've never had success investing in. Traditional consumer goods with these heavy inventories, retailers. So, yes, to see this, that's definitely what I would consider tech because teledentistry, it's almost like **Teladoc**, where they're saying, "Instead of going to the doctor's office, we'll bring the doctor's office to you." They say, "Instead of going to the orthodontist, we'll bring it to you and make it much easier and much cheaper."

Lewis: And if there's anything we've learned over the last couple years, it's that people will happily take things delivered to their doorstep, pretty much regardless of the industry.

Solitro: I think I'm a very active person, but if you tell me, "Hey, you don't have to go to the grocery store, you can go through Instacart," or, "You don't have to go to the doctor, use Teladoc," it's one less person for me to have to see and pay an inflated amount of money. I'll pinch pennies here and there. Plus, I have two daughters and a son on the way. You're telling me I could spend $1,900 for braces instead of $5,000 to $8,000 apiece. I know my wife was telling me she had to wear braces for over two years to have some correction. I can only imagine how much that was costing her parents. This is just a win-win on both sides for me.

Lewis: Good for consumers. And it seems like it's going to be good for them as a business as well. There's one thing I think that's worth highlighting here. They are not profitable, as you might expect for a company that has recently gone public. The spend is coming on acquisition. That's really what's taking them into the negatives. A lot in SG&A and marketing. We talk about software businesses a lot. Some of the companies we're going to be talking about check this box as well. You spend a ton early on to scale your company. And then you have the lifetime value of the customers that you bring. Takeover. That exceeds whatever you spent to bring those customers in. I buy that narrative for a software business. I worry a little bit with a more consumer packaged product. If someone buys something, or they have this orthodontics kit delivered to them, they aren't a lifetime customer, necessarily. They're being serviced themselves. Once they have their teeth all in order, that might be it.

Solitro: Well, then you have the retainers. They also do the retainer business. You do have that. One thing I like to say is, they're in the ultimate land grab right now. They have a couple competitors. I know Candid is a notable one. I was looking through their S-1. I think they had three other competitors that are like them. So you have to remember, Invisalign, their patent came off in late 2017. 2018 was pretty much where these guys had to start pumping out as much marketing as they could to acquire as many customers as they could. I think they've been in operation since 2014. It's pretty much been in preparation for this ultimate land grab that's going on right now. It's almost like you have to be in the market for it. If you search invisible braces or Invisalign, of course these companies are going to pop up, because that is becoming more popular. Especially for older people that didn't have braces in middle school or high school, they don't want to be walking around with mouths full of metal right now. That's definitely what I would be doing, I'd go the invisible route, especially if you're saving money and it's less time. So I think people are going to be looking for those alternatives. And it's that land grab. That's the only term I could really use.

Lewis: The counter to that point is, if you have a family of three, you spend to get the first kid, from a marketing perspective. And if a family has three and all three need braces, well, there you go, you're fine. You can get the word of mouth going, and then the business results will just take over.

We're going to switch gears and talk more traditionally tech here. Our second company that has gone public in the last month is Cloudflare. This one's going to need a little bit more explanation, Joey. [laughs]

Solitro: Even for me. [laughs] They're basically a cloud platform. They make sure all of your mission critical applications are operating as they should to prevent downtime for your website. In the increasingly digital world, outages can be the death of your company. We talked about the same thing with **PagerDuty**, where they would alert the exact person that you would need to fix a specific problem. These guys help you monitor everything and also they prevent cyber-attacks. I was looking through their S-1. They say they block 44 billion cyber threats from 20 million internet properties daily.

Lewis: Which is baffling.

Solitro: Yes. I thought that'd be an annual rate. 44 billion cyber threats are blocked from 20 million properties daily. And then, they have customers that include SaaS superstars, **Adobe**, **HubSpot**. Then you've even got big retail names like **Shopify** and **Walmart**. But then you've even got, they're doing this for the FBI, the U.S. Department of State. If organizations like that trust Cloudflare to do what they do, they must have a great product. They have 74,000 customers right now. They've added 7,000 this year. They've still got a lot of companies that can be added to this mix.

Lewis: Working with the government is generally a pretty good stamp of approval, huh?

Solitro: Especially the FBI and U.S. Department of State. That's no joke.

Lewis: For this company, all of that has materialized into a pretty good growth story, as you might imagine. The tailwinds here are very strong. I don't think those cyber-attacks are going anywhere. If anything, I think they're probably going to become more prevalent as we move forward. This was a company that actually enjoyed reaccelerated revenue growth. For the first half of 2019, revenue hit 48% year on year versus a 2018 growth rate of 43%. You love to see that acceleration.

Solitro: I love to see accelerating revenue growth. It definitely shows that either the business has been getting more attention from the companies that it should, or their marketing spend was going as they wanted. I always go back to our favorite statistic, the net dollar retention rate. That's been over 110%

for the last eight quarters. Their existing customers are consistently spending more. And, they are adding a good amount of customers. That's when you get that beautiful cohort analysis, where they're adding more clients, existing ones are spending more. This accelerated revenue growth, while it might decelerate starting next year, it's still well over 40%. I think the compound annual growth rate since 2016 was over 50%. That's very impressive.

Lewis: When you can grow your business without having to add any new customers, that's awesome. And then, other new customers that are coming in are gravy. That shows you are building a product that people want, people are increasing their spend with you, and they're very happy as customers.

We teased this, but this company is losing money. It's because of sales and marketing. They are investing heavily, much like Smile Direct. That's kind of going to be the theme of today's show, is investing heavily because the opportunity is there for all these businesses.

Solitro: Exactly. There are some red flags that come with Cloudflare that I don't traditionally see with the SaaS companies that I follow. This is one of the reasons I did not purchase Cloudflare. I actually own Smile Direct, for full disclosure. But when it comes to Cloudflare, they've had two mass outages in the last year. For a company that is supposed to keep my company up and running and prevent outages, to have two outages in the last year? That's pretty bad. And then, they stated in the last week that they may have violated U.S. sanctions by providing services to terrorist organizations and drug traffickers. Their defense over this is, "Hey, we couldn't say this going to the IPO because we were in a quiet period." I think, well, how convenient for them.

And for them to not have known that ahead of the filing … I feel like you should know your customer base better, or do your due diligence on them, and say, "We're going into the biggest liquidity event in our history. Maybe we should make sure we're not servicing some terrorist organizations."

Lewis: Yeah. The generous interpretation of that, just to dive into the idea of a quiet period for a second, is, when you have this filing out there, management cannot go out and make certain comments about the company. It's something that is part of the IPO process. If they were to have discovered it, truly, during this period, management would have been in a position where they probably couldn't have talked about it. But, I mean, yeah … this seems like a pretty big deal.

Solitro: It's the ultimate "come on, man." I was on the fence about buying this one. As we've talked about previously, I buy a lot of IPOs on day one. I have a completely different investment strategy than most people and even most Fools here. But that was the one that pushed me over the fence, like, "Yeah, let's wait on this one."

Lewis: Yeah, I can understand that. [laughs] There's some red flags there.

Solitro: There's so many great tech companies out there, I didn't have to force this one.

Lewis: I feel you. OK, we're going to talk about Datadog, a company that just went public this week, we had to get up to speed quickly on this one because shares just hit the public markets this week, Joey.

Solitro: Datadog is a monitoring and analytics platform. What they're doing is, they give you a real-time insight into your company's entire technology stack. You could be looking at all your different servers, applications, all your different cloud-based softwares, and you're seeing it in one spot. It's almost like giving you a bird's eye view of your entire organization. You know, if something's going wrong, where it's at, it allows you to search it. It's basically that key player in digital transformation and cloud migration. It feels like every software company we talk about does the same thing. It's focused on the digital transformation and making it better for customers or businesses finding your service. Datadog, they've made it easier, and put it all on one platform.

Lewis: Even as someone who follows this space — I know you and I both talked about this before — it can be tough to really separate what a lot of these SaaS companies do. I know that you have some tricks for getting to the root of, "Who's truly the best in class provider here?" There are some company metrics that you can help do that with. I know that you like to ask around the Fool for some of the subject matter experts that work in spaces. You have a couple other tricks for, also, getting to the bottom of this stuff with online forums and things like that.

Solitro: How I'll originally go through an S-1 is, I'll completely ignore what a company does. I might know, it's a tech company. I'll look at the numbers first. And when I see over 80% revenue growth and net dollar retention over 140%, a growing customer base — everything about Data dog from the financial standpoint, I loved. Then I back into, now let's find out what these guys do and what kind of competitors there are. Then, seeing, with the rise of data, and I think it's going to be a five-fold increase in the amount of data companies have to be analyzing over the next 10 years, finding companies that can make sense of it, monitor it, and make the digital process easier, is key. So then I go to tech players here at The Fool. Of course, we use Datadog. Then I'll check sites like G2 Crowd or Gartner Insights, and I'll see what these other developers, people that actually use software, say about these companies. I think it was like 4.5 stars. I'm seeing all these as-good-as-it-gets ratings in comparison to their key competitors. So then I'll look at the competitors. And yeah, it checks out, the reviews aren't as good. They're basically saying, because Datadog is unified platform, where all the other major players integrate within, it creates that all-in-one solution, which is another keyword, I always like to look for. All-in-one solution. They do what other people do, but they combine it all. There might be a competitor for a specific division, but not the entire company.

Lewis: It's great to be a full service provider. It's a pretty excellent space to be in. Listeners, tell us if you've heard this one before: they're a SaaS company, they've got great margins, and they're losing money because they're investing heavily in SG&A. Is that pretty much the easiest way to sum up the financials, Joey?

Solitro: Yeah, pretty much. But I will say — this wasn't confirmed by management or anything — I have seen that they do have previous years where they did reach profitability. I found a couple of different blog posts from insiders, but they wouldn't confirm because they weren't supposed to be saying it, but it's like, three of the last seven years, they were profitable. And you look at the margins, they're not burning a lot of cash, not losing a lot of money. It almost seems like they ramped up spend going into this IPO to boost those growth rates, which makes sense. But even then, their net dollar retention over the last 12 months was 146%. In 2017, it was 141%. In 2018, 151%. Those are statistics where I fell in love going through the financials. I don't care what this company does, I'm going to find out a way to love it.

Lewis: [laughs] I think at some point, we may have to build a small shrine to the dollar net retention figure in the studio so that we can occasionally bow to it.

Solitro: Over 140%! That's almost unheard of these days! There's only a few companies. This one, and I think **Twilio**, and I think PagerDuty was up there, too. Those three companies lately got my attention. Definitely a great statistic.

Lewis: It's the kind of thing you almost have to do a double take on. It's proof. You go to the forums, and you read, "OK, this seems to be a best in class provider." And that's borne out in the metrics as well. You don't get a number like that unless you are proving your value to customers and they're increasing their spend with you.

Solitro: Exactly. I was going through the timeline of the company. It started as this base platform. They did one thing. Then they added another solution. And they've added three new solutions in the last three years. People trust the brand. They know that they're very good at what they do. So then they're like, "We added this to our platform. It's an easy bolt-on. We think you want it, too." That's great to see. That could be the primary reason why we have these three great net dollar retention rates. That could be exactly why they waited to go public, so they could say, "Maybe 2016 was 120%," or something like that; it couldn't have been as great. But they knew, "If we ramp up spend, go public in 2019, we're going to have some great statistics to show for it."

Lewis: It actually brings us to an interesting point here. IPOs can serve a lot of different purposes. Companies can be looking to get a lot of different things out of IPOs. At core, they are supposed to be capital raising events. But it seems to me, companies like **Zoom** and Datadog in particular, I'm thinking about here, these were launch parties for these companies. I think people that were in these industries probably knew the businesses fairly well. But for people that are investors or just business enthusiasts, they were probably names that they didn't know. But you start throwing some big numbers out there like this, you start ramping up your sales and marketing spend on the customer acquisition side, people are going to start to learn your name, especially when you're going public.

Solitro: Absolutely. And yeah, I think that's where a lot of these investment bankers come into play. They have their value for processes like this. But I also think, with how popular IPOs are getting these days, more retail investors are checking those IPO boards, seeing what's coming, and actually clicking the S-1s. I think we're doing a great job of spotlighting companies coming down the pike. For companies like Datadog, with these type of statistics — now, you wouldn't think a cloud player would get as much attention as they have. But I think that's just how we're all growing as investors, and becoming more aware of the companies coming public.

Lewis: Yeah, we've been seeing all these headlines about private companies for such a long time. People are eager to get their hands on them.

One thing I did want to get your take on before we wrap up is, people will occasionally look at a company that's gone public and say, "It's trading 15% where shares were offered. That seems like a broken IPO to me." I think that it's worth diving into that and understanding the incentives of a public offering.

Solitro: I hate the term broken IPO or mispricing. If a company's stock drops, it doesn't mean it's a broken company in any way. How I like to always talk about is, say you run a bakery. You spend years sourcing the right ingredients, perfecting your recipes. Then you go to open up shop. But then someone's like, "We'll do that offering to the public. We'll run that front of the shop. We'll buy your pastry for $10 that cost you $3." And you're thinking, "Holy crap, yeah, that's a lot of money. Let's do that." Then you walk out on day one, and you look up at the board, and it's $18. And you're thinking, "How much money did I just leave on the table?

Now, if you do a secondary offering down the road, or anything like that, you might want that $18, where then they just jack it up to $24, whatever the market's paying for it. That's where I really encourage companies for these direct listings that they can — now, if they need to raise capital, by all means, price based on what the market's saying. Seeing these big pops doesn't mean it's a great IPO. It just means those investment bankers and their very wealthy clients are now [wealthier]. You can see it as, these companies build themselves up over a decade, and then these investment banks make their clients as much money in one day as those people made over the last 10 years. I'm not a huge fan of these IPO huge pops, because I feel like they left more money on the table. But a company like Smile Direct, I think that is a phenomenal company, I bought it myself because I thought the market reacted incorrectly. To call that one a broken IPO just doesn't make sense. They made more money on that day of the IPO. Sorry the investment banks and their clients don't have as much money in their pocket as they did when they bought on day one. But hey, you have to lose sometime. If you're not focused on the long term, then you shouldn't have bought the company in the first place. But I'm looking 10, 25 years out, and I'm very confident with where I purchased.

Lewis: Yeah, there are different incentives for pretty much everyone along the chain. The one thing I will say with the broken IPO thing is, it's a bummer when shares are finally publicly available, and retail investors get in, and they have a chance to finally buy a company like Lyft or Uber, and so often, those big names are people's first experience with investing. They're like, "Oh, I take Uber all the time! I have to get my hands on this, it's a no-brainer!" And sometimes people get bit by that. And it's unfortunate. It's a painful investing lesson. But when you're thinking about how companies raise capital, yeah, you want to be maxing out the valuation that you're exchanging your equity for.

Solitro: Yeah, that's the issue. Companies used to come public — I think **Amazon** came public in the third year of their existence. I think **eBay** was within the first five years. A lot of these companies used to come public so quick, because that was how they accessed capital. Now, there is so much dumb money in Silicon Valley. You could be raising a billion dollars, and you're two years old. And hey, we can push off an IPO for 10, 13 years. Times have changed with how companies raise capital and where they can access it. It's great for innovation. But for retail investors, we have to wait a very long time, and we might have to pay three, four, five times as much as we would if they would have gone public earlier.

But you always want to focus on the long term. I always say, take that 10-year stance. If you're like me, take that 10-25-year stance. Take Datadog, it's valued around $11 billion. 41X the last 12 months' sales. Pretty hefty. But if they keep these growth rates up, if they can keep it over 60% over the next three years, that's not that bad. If you're focused on the long term, and you're actually invested in the company, not just for the next earnings report, then I think you'll do well.

Lewis: We talked about three companies. Before we wrap up here, I do want to ask you, I'm going to have to force rank those. Where are you putting them? Which one's your top choice here? Which one are you a little bit less excited about?

Solitro: I had a feeling you would do that. I own Smile Direct. I can say I did that because it was only trading at about 12X sales for over 100% growth. They have the highest growth of them all and the lowest multiple. That was an easy one for me. Then I would go Datadog. Yes, it's more overvalued than Cloudflare. But I think the runway is more significant for them. Cloudflare, I feel like a lot of companies will continue to do this, I feel like I've read so much about these companies that enhance performance and give you real-time insight into mission critical applications. I feel like their competitive moat isn't as significant as a Datadog. So, I would go Datadog number two then Cloudflare number three, even though Cloudflare has a, quotes, "better" valuation than Datadog.

Lewis: I think it's reasonable to see the dust settle a little bit on some of the things that are outstanding right now with Cloudflare.

Solitro: Absolutely. I'm going to wait for both these to come back down to earth a little bit. Now, Datadog may never do that. Say they just blow out the earnings report then keeps raging on. Then I'll be standing there clapping and rooting for them. But Smile Direct's the one that I could see the long-term runway and actually get behind the valuation think and think the market has this one wrong.

Lewis: What's the investing maxim? You pay for quality? [laughs] You know? When businesses are putting up good results, you're going to have to pay a premium. Joey, thanks for hopping on today's show!

Solitro: Thank you very much for having me!

Lewis: It was a pleasure. Listeners, that's going to do it for this episode of *Industry Focus*. If you have any questions or you want to reach out and say hey, you can shoot us an email over at industryfocus@fool.com, or you can tweet us @MFIndustryFocus. If you want more of our stuff, subscribe on iTunes, or even catch a ton of bonus stuff over on YouTube. There's actually a video on our channel breaking down all the different elements of the IPO chain and the incentives there. Check that out. As always, people on the program may own companies discussed on the show, and The Motley Fool may have formal recommendations for or against stocks mentioned, so don't buy or sell anything based solely on what you hear. Thanks to Austin Morgan for all his work behind the glass today. For Joey Solitro, I'm Dylan Lewis, thanks for listening and Fool on!

CATEGORY

1. Investing
2. Tech Stocks

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TICKERS GLOBAL

1. NASDAQ:DDOG (Datadog Inc.)
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