Askeladden Research Document: Zix (ZIXI)

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Why am I looking at this? / Executive Summary

Date Today: 2018-02-24

Price Today: $3.90 / 13.3x NOPAT / 8.7x EBITDA

Fair Value Estimate Today: $4.76 / 17.5x NOPAT / 11.4x EBITDA (implies $199MM fair EV today)

Position Size Today: will attempt to buy ~250 bps below $4.00 on Monday; would be willing to add another ~150 bps after thinking about it a bit more and catching up with mgmt. (Note: 300 bps actually bought on 2/26 at a weighted cost basis of $3.95.)

Date Last Time: 2018-02-08

Price Last Time: $4.06

Fair Value Estimate Last Time: $4.50 / 20.0x NOPAT / 12.7x EBITDA ($9.6 / $15.2MM respectively) - implies $193MM fair EV

Position Size Last Time: zero

BLUF: Zix (ZIXI) is like Globalscape (GSB): a best-of-breed, cash-rich, strongly cash-flowing niche software company, except with smarter management, a much stronger competitive position, current audited financials, and few to no questions around long-term market viability. I'm willing to buy management's story that weak 2018 guidance (4% revenue growth) is transitory; even if it's not, no more than GDP-like 2-3% long-term growth would be required to support the current valuation anyhow, and the bounty of cash (plus a sizable DTA that will continue to convert to cash) combined with the highly recurring revenue should cushion any bumps in the road.

Explanation: Zix is a local, D/FW-headquartered software company that I've followed for a few years now. I liked the product and the long-term opportunity - email encryption would seem to be a relatively stable and growing space - though I had some questions about “product vs. feature” and whether “bundling” by competitors like Proofpoint (PFPT) would perhaps weigh on their revenue growth.

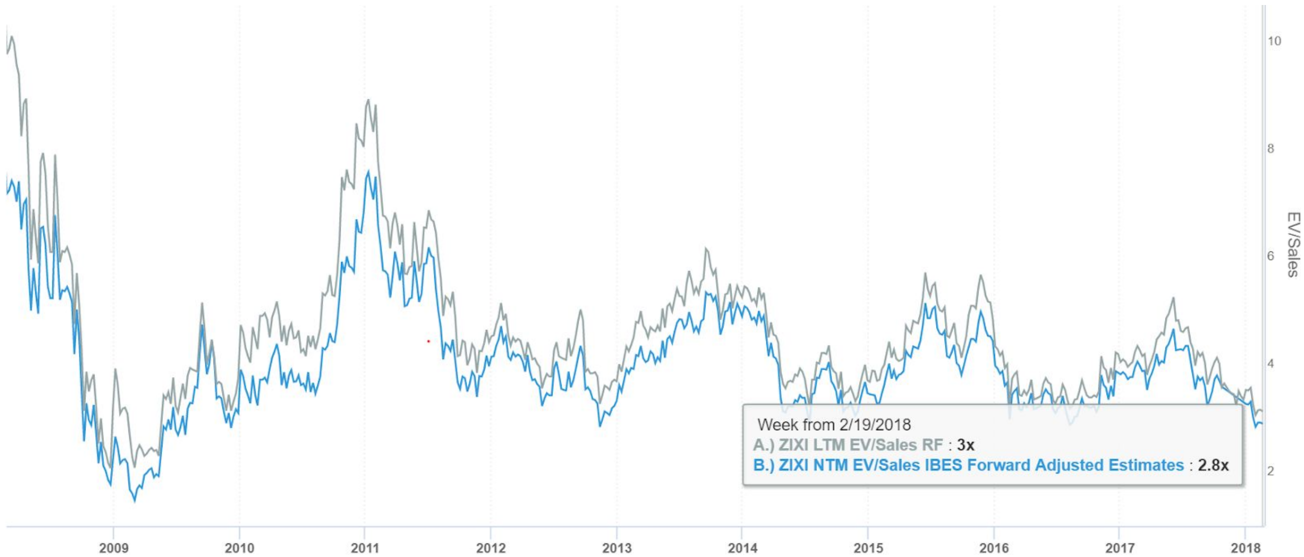
The biggest hurdle, unfortunately, was valuation: Zix has a very large DTA on the balance sheet, and as such hasn’t been paying cash taxes; some investors (such as one who wrote it up on VIC) used the egregiously indefensible valuation methodology of valuing it on a multiple of near-term, tax-free FCF, rather than tax-effecting and NPV-ing the DTA (or using its book value as an equivalent). Unfortunately, it seemed many other investors were following the same flawed approach, and therefore I didn’t have much hope of the stock getting cheap in the near-term.

Well, a few things have changed: first of all, I think management’s decisions over the past year have been mostly sensible (with one curious potential exception), and while the “bundling” phenomenon does indeed appear to be real and important, I think management is responding appropriately.

Second, given that Zix generates substantially all of its revenue domestically, the tax bill massively boosts their post-tax free cash flow, while concomitantly decreasing the value of their DTA, resulting in (on net) a modest boost to their intrinsic cash flow-derived value, but more importantly dramatically reducing the relevance of the DTA to analysis and valuation.

Third and finally, a confluence of several challenges (M&A at a few large customers and some other customers’ transition to Office 365) has created some churn, causing 2018 revenue guidance to be in the range of 3 - 5% vs. ~9.3%, ~9.9%, and ~8.7% in the prior three years (note that revenue growth in 2014 was merely 4.7%).

The market didn’t like this trend through late 2017/early 2018, and post the recent earnings announcement, sold the stock down below $4. Although the below chart does not capture the value of Zix’s DTA (which most data providers don’t offset to EV, it seems), it does at least directionally capture that Zix is that rarest of birds: a stock trading at (on the basis of both trailing and forward EV/Rev) valuations close to the *lowest* it’s seen since 2009.



This is not an "edge" thesis in the sense that I don't believe I have any special insights into Zix's technology or the evolution of the competitive landscape. It's much more of a thesis similar to FOGO, actually: simply having less emotional and analytical volatility than the market, and realizing that for a fundamentally sound company, things are likely never as good or as bad as the last comps print. Taken as a whole, there's actually been some good with the bad at Zix, including some notable customer wins, continued revenue renewal rates of 90% despite the challenges of 2017, and the potential for add-on "bundled" products to serve as a growth vector even if their core encryption offering slows down to more GDP-like growth.

Ultimately, even if long-term results mirror 2018 guidance - i.e., 3 to 5% revenue growth, with solid profitability and management not burning the capital - Zix's cash flow should be worth meaningfully more than its current price, and the recurring revenue, cash-rich balance sheet, low ARPU ($18 per user per year on average) and compliance/regulatory-driven nature of its product combine to make it seem like a relatively defensive investment below $4 with a seemingly attractive forward return profile.

What's a Zix Anyway?

Zix, headquartered in Dallas, is a ~$70MM software company (all recurring) with ~30% Adjusted EBITDA margins. The corporate history of Zix is not terribly relevant, but modestly interesting: from a conference in 2012:

> *Zix was formed in 1998, founded by a serial entrepreneur by the name of David Cook. This is the fourth technology that David has invented that has become part of a public company. He's best known for having invented the technology and founded Blockbuster Music and grew that to 4000 stores and sold it off to Wayne Huizenga. And then he also created RFID technology that is used on railcars and Toltec systems around the world. Sold that technology in 1998, and his investors said, what are we going to do next, David? And he said, email is the largest application in use in*

> *networks today. This was in the late 90s, and it will continue to be likely the largest application and use of networks for decades.*
>
> *And email was created in the context of what were private networks in the 70s and 80s and early 90s. And those private networks provided the underlying security such that the application designers for email never had to worry about security.*
>
> *In comes the Internet. David views and, of course, it is accurate, that email is going to be around for a long time. It is going to move into the Internet. The underlying infrastructure of the Internet, as you know, provides no security. So now we have the largest application in use in the world today that is insecure now sitting on an insecure platform.*
>
> *So he said, we're going to build a facility to bolt on encryption, if you will. So the email can be used for sensitive exchanges, most logically healthcare, finance, government and frankly, any email exchanges that contain sensitive data.*
>
> *So we are an encryption, email encryption services Company designed in a software-as-a-service platform that is both technologically as well as financially. So we are 100% subscription model and have been since our inception.*

As of today, Zix is the leader in the email encryption market in the U.S. (and globally). The company has estimated that the U.S. market is ~$150MM, with the global market (including the U.S.) being ~$250MM, giving Zix 25 - 30% of the global market and 35 - 40% of the U.S. market.

At the Liolios Gateway conference in September 2016, management provided the following competitive commentary:

> *From a competitive standpoint, Zix is the best-in-class provider. There's a few other pure play providers in the sub-$5 million, sub-$10 million area that we compete with. But a lot of times what you'll see is the email hygiene vendors provide a little bit of encryption, a little bit of privacy solutions that you'll see.*
>
> *A lot of times, they are in there selling a bundle. And there's a lot of times where the customer wants best in class so they may be buying from Mimecast, Sophos, or Proofpoint and then they are buying the encrypted email from Zix. And it all works together and ties together.*

A quick Sentieo search confirmed this: aside from a Canadian penny stock that seems to enjoy press-releasing every customer win, companies like j2 Global (JCOM) and Proofpoint (PFPT) only seem to mention email encryption in passing, while discussing their broader, integrated offerings.

The majority of the customer base is in healthcare and financials, where regulations like HIPAA and so on create a compliance need for their products:

> *So who are the customers that Zix keeps? We think this is very important to our business. So one of the things we are very deep in is compliance for our customers. Helping our customers comply with different regulations.*

> *So about 75% of our business comes from financial institutions and healthcare. So if you look at the first key customers we talk about on this slide is US FFIEC regulators and then US banks. So about 25% of our total revenue comes from financial institutions in the US.*
>
> *If you then look at the next big chunk of our revenue or the actually biggest, it is 50% of our revenue comes from healthcare, healthcare providers, and insurers. A lot of who are dealing with regulations around HIPAA and other regulatory compliance.*
>
> *So we are very proud of the type of customers that we have. We have a very strong market share in that space and it really comes down to the products we sell and the way that they help their customers keep their information private and secure.*

In 2017, management noted that 30% of banks in the U.S. are Zix customers; as I'll discuss later, they also recently won a big implementation with a top-5 U.S. bank.

Why is Zix best of breed? It's more behavioral / network-effect driven than it is algorithmic. Again from the September 2016 Liolios Gateway conference, management's explanation:

> *We are focused on making the sender and receiver have a very positive experience. If you go back -- encryption for email has been around for years, from DGT to all other types of secure email and encryption. And it's all been -- it has been a slow adoption in the past because it was so hard.*
>
> *If the sender or receiver -- if they have to go out and get some keys for that person or they have to do three or four clicks, they are not going to want to adopt that solution. Just makes it too hard and too cumbersome. What Zix has done over the years is really focus in on that sender and recipient solution and making it very easy and making a very transparent.*
>
> *So what happens is our customers -- what we sell to our customers is what we call ZixGateway. And that gateway solution can either reside at the customer's premise or we actually host that for our customers as well.*
>
> *So think of it -- you are sitting there. Your company has a ZixGateway. You hit send on your email, it goes out the email server. It hits the ZixGateway. It then says: This is something that should be encrypted. Let me go check the ZixDirectory and see if I have the encryption keys for the person you are sending this to -- for the recipient.*
>
> *If it finds it, it automatically encrypts that at the gateway, sends the email. It hits the other person's gateway and is decrypted there and automatically, seamlessly goes through to the end user or the receiver of that email. The sender didn't do anything and the receiver didn't do anything.*
>
> *So in 75% of our email communications that are encrypted, the sender and receiver don't have to do anything. It makes for very nice, seamless solution. If your end user that you are sending the email to doesn't have a ZixGateway, we have multiple other ways to deliver an encrypted email*

> *that are easy and seamless. And that's the difference in our solution: making it easy and making it transparent for our recipients and our senders.*
>
> *And key to that, I mentioned our ZixDirectory. So years ago when Zix first got into secure email, the decision was made of building this ZixDirectory and building this community of people that have encryption keys in this directory. So we host this, and there's now 54 million users, and we're adding 140,000 members per week to this user community.*
>
> *So we are 54 million users across -- within healthcare and financial. There's a good chance we have somebody you are sending an email to in our directory. So it's a very seamless way to do it, and it really is driving our business as people want to be a part of that community to make that encrypted email a much easier solution. And so this is really a part of the enrichment of our solution.*

From management's other commentary and some broader reading, it seems like user compliance is one of the challenges with encryption: if it's hard or takes more than a minute to get through, they'll just give up and circumvent the system and send an email that *should* be encrypted without encryption. (Reminds me of Richard Thaler's anecdote about how employees at Google overrode the onerous security-access system by propping open a door with a brick.) On the Q4 2016 CC in February 2017, management provided the following commentary as part of their rebrand:

> *We did a very data driven exercise in our rebrand. As part of that we interviewed over 900 customers and specifically a smaller segment, we had a professional brand interviewer talk to our customers. And what they came back to us with is that they made the decision to purchase and to continue using Zix, because they perceived to be the gold standard in email encryption. And gold standard to them represented user experience and how it takes care of the customers that represent it, the customers we keep and it represents our leadership position. The second thing they told us was interesting to me. They said they chose Zix because it was the most secure solution available. And that security doesn't come from encryption algorithm strength. It comes from the filters that automatically assure compliance at the gateway. So our customers really strongly came back to us with these real strong value propositions. So when you see that rebrand with the gold highlight, that's to subtly remind our customers their belief in us as a gold standard. It's been really powerfully received internally as our colleagues are re-internalizing and getting reinvigorated around how important their everyday interaction is with customers and delivering this gold standard in*

For being the "gold standard" of email encryption, Zix is a surprisingly inexpensive service; their ARPU is $18 per user per year but there's a big range - a single user (ex. me) would have to pay $100 per year while an organization with 750 users would have to pay $40 - $48; obviously the implication is that giant enterprises like that top-5 bank are probably paying a fairly nominal cost of $10 - $15 per user per year.

When I initially worked on Zix back in 2016, I did some reading on tech forums about Zix vs. Proofpoint vs. etc and didn't come away with any conclusions that contradicted management's presentation of the story or my general impressions.

Bundle Up, Bucko: Bruised or Broken?

My primary concern with Zix has always been the "product or feature" question that plagues every niche software vendor: for intuitive reasons, it generally seems that most organizations don't particularly want their software stack to contain tons of applications, so pure-play software companies usually have to offer a compelling reason to use their product in addition to the basic feature set you can get from someone else's "bundle."

As noted earlier, Zix's services are often purchased by customers who often have other potential solutions from existing vendors like Proofpoint. I intuitively believed that this was the major threat to the business; management has confirmed that on various occasions. For example, in Q1 2017, discussing the loss of one of their bigger customers:

> ***David J. Wagner, Zix Corporation - CEO, President and Director [15]***
>
> *Well, we perceive it to be more of an anomaly where they had some sort of issue, which we're not completely aware we've done a detailed, but the AVS provided, they needed to free up budget. And when they did that, they went through a bundled solution even now when they had a lesser solution on e-mail encryption side. So with -- really a budgetary driver that drove them to have to move away from Zix.*

Similarly, Office 365 offers email encryption, and some companies have been going with that. Per management at an Imperial conference in December 2017:

> *From Microsoft on the Office 365 front, it's both a tailwind and a headwind for Zix. It's a headwind because there is a lot of companies and customers moving to Office 365. And Microsoft pitches an all-in-one type of bundled type solution or offering.*
>
> *So as much as we have the opportunity to retain those customers and win new ones as they are moving, Microsoft is out there trying to win those customers towards their bundled offerings as well. The positive thing is Microsoft's encryption products and threat protection products aren't as good as companies like Zix's and others that have more best-of-breed type offering. But they are getting in with some of those customers and I will hit that retention rate in detail a little bit later.*

At the same conference, management's reference to "advanced threat" makes me think that the consolidation-driven M&A churn they saw was also related to bundling:

> *Two things we have talked about and mentioned on our Q3 conference call. We have seen about $2 million of excess churn from M&A. We had a couple of our largest customers that were*

merging and, via that, ended up losing both those customers for different reasons as they came together or are starting to come together. And we were architected out of the solution, unfortunately, for different reasons, as they really had to focus in on their advanced threat position that they were in. We also had a little bit of other excess churn there.

And we've also seen, as we mentioned on the call, 200 basis points to 300 basis points of additional churn from Outlook 365 with customers moving there. And as I mentioned earlier, it is both a headwind that we face, but it's also a tailwind and has its opportunities as well for us.

All of this combined to amount to revenue guidance for 2018 that was well below the double-digit growth rate that management would like to see (or the high-single-digit rate that they have been seeing for the past three years):

However, the excess churn due to M&A and competitive pressure is slowing our near-term revenue growth and impacting our 2018 guidance [3 - 5% revenue growth]. This excess competitive churn we are experiencing is primarily from our on-premise appliance customers, which now represents about 20% of our ACV, down from 27% of our ACV a year ago.

We believe the success we're seeing with our cloud-based e-mail security solutions position us well for expanding our market position and building a foundation for stronger levels of growth and profitability moving forward.

The question, obviously, is whether this is a bump in the road, or an inflection point whereafter Zix will grow at a much lower pace than it did previously. It is worth noting that thanks to the annualization of a couple small acquisitions that Zix did, and the seemingly strong traction of some of their new upsell products, there's likely not going to be more than low single digit organic growth for their "core" encryption product (which, while not explicitly broken out anymore, probably comprises $60MM+ of their $67MM in ACV).

At the risk of being cavalier, there's really not a lot here that makes me nervous, at least relative to what the market is pricing in. First, as of the call a few days ago, management and analysts see the market as still growing at a reasonable rate:

David J. Wagner, Zix Corporation - CEO, President and Director [5]

Well, so the -- it's really a transition from on-prem to cloud, and so that, Gartner would have the secured e-mail gateway growth in the low single digits. Our perception is the encryption part of that is growing in the mid-single digits.

Management, previously, has noted an increase in general interest outside of the compliance-driven space relating to email encryption, given all the high-profile hacks. For example:

That's what we're seeing in kind of the Google search data [from earlier: In fact, over 25 million Google News search results were related to email encryption in 2016 compared to just under 10 million in 2015.]. We're seeing an increasing interest in email security in all verticals. As you can

> *see our numbers, the healthcare, finance, title remain the big pieces. But the trends that we see that we like are the bigger enterprise bank. It's coming back and really readdressing encrypted email, because they really care about their customers and consumers' data. Those are the kind of trends we really like that we're seeing.*

Domain registrar GoDaddy (GDDY), meanwhile, mentioned the same thing on a call back in November 2016:

> *We also know that many small businesses lack the capability, understanding, or resources to fully secure their technology and online presence. We've developed some really differentiated offerings, like secure email, which allows encryption and archiving for customers like medical practices which require HIPAA compliance. And we're testing several other complementary offerings, including site backups, secure storage, site scanning and malware removal, just to name a handful. The demand is absolutely there. So you will see us offer a broader range of security tools going forward.*

Generally speaking, I find it hard to believe that in the absence of the repeal of HIPAA or something, the market for email encryption is going to vanish overnight. Zix has noted that despite the advent of Slack and other communication tools, they continue to see steady growth in their clients' email userbase, so a combination of a growing workforce and more adoption of email encryption for more purposes should make the market grow okay; Zix just has to keep winning a decent share of that.

And, notwithstanding the challenges, it seems like Zix will be able to do that. First, despite what seems like a confluence of challenges: i.e. major consolidation at three of their 20 biggest clients (like what happened to TechTarget (TTGT) a while back), combined with an ongoing transition of one of the most widely-used pieces of business software in a world, Zix still achieved 90% revenue retention and will still grow 3 - 5% next year - that's not what they'd hoped for, but also isn't catastrophic. Meanwhile, on last year's February 2017 call, management discussed the positive feedback received in correlation with winning a major piece of business with a top-5 U.S. bank:

> *To demonstrate the progress in pillar three, I'd like to share another major success. This win was with the top five U.S. bank I mentioned earlier. This bank has been a customer of ours for a small segment of its users for secure and transparent email communication with banking regulators. However, this top five U.S. bank was now looking to displace their existing internal encryption solution with a more comprehensive, easier to use enterprise solution both internal users and external customers and partners.*
>
> *As is the case at all of the large banks, this bank employs a world-class team of both email and information security experts. They performed a comprehensive review of our email encryption services, our data center as*

well as our personnel and processes. They completed this review, as I expected they would, with a very positive view of the team execs and of our solutions. This purchase represents one of the very first instances where this bank is trusting a cloud provider with production data.

Looking beyond a particular customer, this is an exciting trend that we are seeing. That is the ongoing movement of data from on-premise to our cloud-hosted environment. Our 15-year history of hosting sensitive customer data gives us a big advantage as the preferred provider with the best-in-class security and privacy for our customers and for their customers' data.

Zix has also, through a mix of a small acquisition (Greenview Data - $6.5MM cash paid for a couple million in revenue, with products they can seemingly cross-sell) and some organic development, put forth its own "bundle" that offers competent, though probably not particularly market-leading, products called ZixProtect (malware, ransomware, anti-spam) and Zix Archiving. Customers, per management at the Imperial conference in December 2017, seem to like this:

We all come at it from different directions: Proofpoint from the advanced threats, having the best there; Mimecast coming at it from more an archiving type of area; Zix coming at it more from the gold standard encryption product area.

With our new offerings, our Zix Protect and Zix Archiving, we are competing very well versus both of these players. And feel that as we continue to evolve our solution and offering through our Zix Central platform this year, which really brings together all of these technologies into one painted glass, that we are going to continue to be a formidable competitor across this bundling area for email protection.

[...]

So the good thing is we are feeling very good about that. Zix Protect and Zix Archiving both are performing well ahead of plan. It's exciting for us to get -- to be able to move from -- we plan for it to be small/medium business, so just selling to under 2,000 users. So that's what our business case was based on on the acquisition.

So now that we're having success with the over 2,000 and the product roadmap that we have that really fits well with the enterprise and over 2,000 users, we are real excited about how that impacts the model. So yes, we are having success and our customer base -- some of the things I'm hearing from the sales floor is I'm calling about Zix Protect and Zix Archiving. And they are going well; you are one of our favorite products we have in our infrastructure. It is set it and forget it. And it just works and does what it needs to do.

> *If you are calling us about something else you have, we are interested. Because we love your product, we love the support you give, and so we are willing to take the bundle from you all. So I think that's the testament and that's what we are pushing for.*
>
> *And we are having success driving the bundle to new customers, where a customer's out with an RFP and they were looking for a bundle and Zix wasn't getting that call before because we didn't have the bundle. And so that's driving, and a lot of the sales team is very fired up about the opportunity of selling the bundle now.*

Per the recent February 2018 call, two of their top five wins were competitive displacements with the bundle:

> *2 of our top 5 new customers in the quarter were for our bundle. We're especially pleased with this traction and the fact that we displaced key Gartner Magic Quadrant providers in these accounts, demonstrating the strength of our bundle in competitive displacement scenarios.*

I will point out that the **thing I like the least** (although I'm willing to hear management out) is their unconventional decision to intentionally *decrease* their term length - it seems like it used to be 30 months a few years ago, but is now somewhere in the high teens, as they've "flattened the yield curve" so to speak and made it less attractive to sign up for longer-term contracts. Why?

> *we are reducing the financial incentive for our customers to select long-term contracts in order to increase both the velocity of transactions and the number of future touch points we have with these customers. The addition of our customer success team earlier this year has us more connected than ever with our customers' specific needs and requirements, and is giving us greater opportunities to upsell and cross-sell our newer solutions.*

I'm honestly not sure about that one.

Regardless, in the general scheme of things, is it naive to take management at their word and believe that their business is still well-positioned? Maybe. But it seems reasonable to me that there is a certain segment of the market that will always need a best-of-breed solution, and I believe that Zix's ease of use would be difficult to replicate - not necessarily technologically, but from the simple fact that they have the network effect of having the largest market share position, and thus being able to seamlessly work for many users.

Finally, Zix is also taking matters into its own hands with its go-to-market strategy. Although new first year orders declined modestly from $9.5 to $9.3 million, it's worth noting that NFYOs from all sources other than OEM partners (i.e. Google and Cisco) actually increased from $7.9MM to $8.8MM. From my conversations with management in 2016, it sounded like the OEM partnerships were valuable but lumpy; per the recent Q4 2017 call, it sounds like they're shifting their focus:

> *Taking a step back and analyzing our new first year orders during the quarter, 52% came from our direct sales efforts; 41% through VARs and MSPs; 5% through our OEM partners; and 2% from web sales. Only 5% from our OEM partners means that we experienced another light contribution from that channel. With regards to Cisco, we're still not in a*

position where we can expect consistent new first-year order contributions from them as a channel and we're working with Cisco to find a new and fresh approach to optimize our work together. With Google, we continued to move opportunistically, and see a stronger opportunity to engage Gmail, G Suite customers through Google's channel partners, [then] with Google's direct sales force.

For the full year of 2017, new first-year orders from our OEM partners decreased to 9% of our new first year orders from 17% in 2016, more than accounting for the year-over-year decline in the total new first year orders and the majority of the year-over-year decline in encryption orders.

[...]

For the last 18 months, the majority of our R&D roadmap has been dedicated to accelerating our cloud offerings. In particular, we're investing in ZixCentral, our cloud-based offering, to bring it the feature parity with our on-premise Gateway, and we've made considerable progress on that front. We made improvements throughout the year, and completed the first phase of integrating ZixProtect and ZixArchive into a single pane of glass console and reporting interface. In January, we deployed it across more than 1,600 cloud customers. In April, we'll have our next major release that integrates our bundle into a multi-tier MSP interface with 15-minute deployment, and will provide monthly billing options.

Early in the second half of 2018, we will complete the integration of our cloud bundle with a refreshed user interface and integrated policy management. The main takeaway here is that we're making meaningful investments to position us even more strongly from a product perspective.

Our strategy is to continue building of our best-of-breed e-mail encryption solution to provide a suite of e-mail protection solutions that are targeted to serve customers and compliance industries in the mid-market segment.

Our solutions help assure compliance and security in an easy-to-use and cost-effective manner. When you put all of this together in a cloud-based bundle, with exceptional availability and superior customer service and support, we believe that we're on a path to success.

[...]

In 2018, we will be continuing to work with our existing OEM partners to optimize our work together, but we will be placing increasing emphasis on our MSP and VAR routes-to-market as we believe that they represent a better go-to-market fit for our expanded solutions set.

More specifically, on April 2, we will launch a new managed service provider program that will allow our MSP partners to access our complete bundle from a single interface, including the ability for tiered access to ZixCentral and self-administration of their end users. We are also introducing monthly billing for our MSP partners that move to the new expanded offering. We're excited about the strong early reception of this new offering by the partners who are previewing it, *and we're optimistic about the potential increase to our business, particularly in the SUB 50 mailbox space and Gmail space that had been historically underrepresented in our base.*

[...]

Wonchoon Kim, Imperial Capital, LLC, Research Division - SVP [11]

Got it. And then just to expand on the MSP strategy. Maybe you could talk a little bit about what you need to do there to invest or enable the MSPs to drive that business? Sort of your expectations as we go through the second half of the year and the need to either establish or build upon your existing MSP relationships?

David J. Wagner, Zix Corporation - CEO, President and Director [12]

Yes, so that's a great question. The MSP part is -- one of the areas that we're most excited about is the first place where the full bundle offer is going to be excel -- accessible easily in a single pane of glass with the very rapid deployment with automated key generation, et cetera. So that will roll out on April 2. We've been talking to partners that have literally hundreds of thousands of mailboxes under management that see, particularly, adding Protect and Archive to existing encryption is an opportunity. And then, similar to what we've been seeing directly, we're having new MSP partners that weren't previously considering Zix because we only had best-of-breed, they're now looking at Zix as a very attractive option for the full suite. So I think we're going to see pickup with our existing MSPs, but probably, actually more quickly with new MSPs that we've not yet done business with. So it'll be both sides, that one, Michael.

Valuation

There's more qualitative color I could discuss here (such as the transition to cloud, which they seem to be focused on) but I'm not sure anything else is hugely relevant.

From a valuation perspective, it's worth noting that the company used to have a target of ~25% Adjusted EBITDA margins, but moved it up to ~28% (which they've been hitting). Guidance for 2018 is actually for ~30% margins due to an accounting change - ASC 606 - which better matches the timing of cost recognition for sales commissions on deferred revenue. It won't have a cash impact but given my modeling on Franklin Covey, I'm comfortable with it - management is estimating a $1.5 - $2.0MM benefit.

The math is pretty simple: the midpoint of revenue guidance is $68.5MM, which translates to $20.5MM of Adj. EBITDA at a 30% margin. I'm assuming $3.0MM of stock-based compensation as a cash cost. The only "bogey" here is that for quite a while, the company had some big patent lawsuit bills, but management seemed to imply on the call that it had concluded and will no longer be a drain on cash flow (I'll ask them about it). I'm modeling capex close to depreciation (3.3% of revenues - $2.2MM of annual capex - recent capex appears to have been boosted by the Greenview acquisition), so that gets me to ~$15.2MM of "true" EBIT.

At a 25% assumed tax rate (historically their effective appeared to be a few points above 35), that gets me to ~$11.4MM in NOPAT.

Management has guided to 54.1mm diluted S/O for the year, making the market cap ~$210MM at the price of $3.90. The company has $33MM in cash and the DTA is valued at $25.6MM on the books; I did some analysis and concluded it was worth at least $21MM on a DCF basis, and they probably know the expiry schedule better than I do (plus there's probably some state/other NOLs I wasn't counting). Treating the DTA as an offset to EV, the enterprise value today is thus ~$152MM, representing a pretty cheap ~13.3x multiple to my estimate of NOPAT. Not much long-term growth is really required to justify that number; something around 4% growth would justify a 17.5x multiple, or a share price of $4.75. For what it's worth, ZIXI has typically traded at much higher multiples on an EV/Revenue basis than what my work implies, so any positive momentum from the business might be rewarded rapidly.

Ultimately, I'm really not all that concerned (at 13 - 14x economic earnings) about the competitive environment or the company's ability to drive growth; the management team seems like they have a handle on things. What I'm slightly more concerned about is the potential for dumb M&A; the word "scale" is a bit… concerning?

> ***David J. Wagner, Zix Corporation - CEO, President and Director [11]***
>
> *Yes. So that's a great question, Mike. And that's really the highlight of this past quarter is the demonstrated proved capability of the ZixProtect solution that we acquired. The more we have it in with the clients, the more we're aware or convinced of its effectiveness, against malware and advanced threats as good as anybody in this space. And the road map that we're building out there with our sandboxing capability and our URL direct -- redirect features, they're different than anybody else in the market, I think in many ways for many customers are best-in-class implementations for advanced threat protection. So the technology is super.*
>
> *On the archiving side, what we have is an S3 back-ended cloud-based solution for giving a true transparent second source with an elastic search engine that's really fast and has some real exceptional features. So the technology piece of it, we're really excited about. It's really about as we think about M&A, it's really about how we get scale faster, so we can continue to make investments and build out the suites. So we're looking at things that bring scale and then we're also looking at adjacencies that might add technology; but primarily scale focus as we look at our M&A road map.*

I'd personally rather see Zix be acquired than be the acquiror, and it's pretty much a perfect acquisition target for probably a dozen software companies (or even private equity), but we'll see. The bright side of M&A is that Zix actually has way more DTAs than are on the balance sheet (they have so many that they can't possibly use them all organically), so the bright side is that they have what I'll call the Cott (COT) bailout - even if they pay brain-damaged multiples for stupid assets (like Cott did, seemingly repeatedly as I recall), not having to pay cash taxes can save your bacon.

I've reached out to Najim to set up a call with management; questions I intend to ask are below.

Ongoing Monitoring/Journal

2018-03-01: In-Person Meeting with Dave Wagner, CEO

2018-03-01: 3:30 PM to 4:30 PM: meeting with David Wagner, CEO of Zix (ZIXI)

Overall takeaways:

1) The Office 365 threat is real (to the point where Zix views Microsoft, rather than Proofpoint/Mimecast, as their primary competitor). However, Wagner segmented the business into four portions: their multitenant cloud (25% of ACV), their private cloud and "virtual on-prem" (25% and 30% of ACV respectively), and their on-premise (20% of ACV). Retention has been stronger than average with the first group, in line with average on the second and third group, and substantially weaker than average in the fourth group, which is why they are focusing their attention on transitioning those existing customers to cloud. Note that as of Q4, 90%+ of new deployments are cloud.

The "bull case" is, essentially, that independent of whether or not ZIXI's efforts to forestall this issue drive results, the on-prem portion of their business should continue to shrink over time and thus the headwind should abate. The "bear case" (per Wagner) is that Microsoft is, at least at the moment, focused on upselling security and there could be spillover into the virtual on-prem business (although they have not seen this as of yet and retention rates / churn in that category have been stable).

2) Apparently the 1-yr vs. 3-yr contracts are a strategy they took from Thoma Bravo at Entrust that led to higher upsell, etc. However, they're not dogmatic about it, and in areas where they see a risk of customer loss, they do still use the 3-year to try to lock in the relationship.

3) The premise behind bundling is that it allows them to leverage the same distribution chanels from a different angle: in a hypothetical example, a managed service provider might have 400K mailboxes of which only 10 - 15% are targets for encryption, and then Zix would get a portion of that, plus bundling add-on products. The other 340K mailboxes, however, have a much higher penetration rate of archiving and advanced threat protection, which potentially allows Zix to drag encryption along.

4) To that end, they do seem to want to do M&A for the sake of scale here, but at least in theory, they seem to say the right things (open to scale via being acquired as well as acquiring, using buybacks as an IRR hurdle, etc.) Given the cushion of the cash on the balance sheet, the strong cash flow, and the off-balance-sheet DTA, I don't think it's terribly likely that they do something hugely value-destructive.

5) Overall, my impression of ZIXI is more or less what it was when I went into the meeting: a strong core product that probably doesn't have the fantastic long-term growth prospects that bulls thought

it had, but is no slouch and isn't going away either. Management is rational and competent and seems to be thoughtfully addressing what they can control. Some of the headline issues are transitory; some are perhaps more permanent and challenging in nature, but at the current valuation most of that appears to be baked into the price and then some.

6) It will likely be quite a while before numbers start to look better and they may get worse in the meanwhile (for example, one of the healthcare contracts was extended through 6/30 but will roll off at that point, perhaps offsetting the uptick of NFYOs in 2H '18). As such, there may be continued opportunities to build the position over the course of 2018.

[MEETING NOTES REDACTED]

2018-04-20: Trimming on Strength

Date Today: 2018-04-20

Price Today: $5.00 / 18.5x NOPAT / 12.1x EBITDA / 3.1x Revenue / $210MM EV

Fair Value Estimate Today: same as last time - $4.76 / 17.5x NOPAT / 11.4x EBITDA (implies $199MM fair EV today)

Position Size Today: ~120 bps (sold roughly two-thirds of original shares)

Date Last Time: 2018-02-24

Price Last Time: $3.90 / 13.3x NOPAT / 8.7x EBITDA

Fair Value Estimate Last Time: $4.76 / 17.5x NOPAT / 11.4x EBITDA (implies $199MM fair EV today)

Position Size Last Time: 300 bps actually bought on 2/26 at a weighted cost basis of $3.95

BLUF: The old me probably would've been all out of ZIXI by now, but the new me is trying to be modestly more tax-efficient and somewhat more cognizant of the fact that my valuations tend to skew conservative relative to other people's, so I continue to hold a small position.

Action Items: none

Documents Reviewed: None.

Explanation: I'm kind of lazy about writing down memos when I make position size changes on price movement in the absence of news; I might need to consider finding a somewhat less intrusive or less formal format for "no news" price-based transactions, purely for the sake of decision journaling.

Anyway, nothing much has happened fundamentally at Zix since I last wrote them up and met with CEO Dave Wagner… in fact, if anything, there's something that might be incrementally negative. The company paid $15 million (a little under half of its cash balance) to acquire Seattle-based Erado, which offers a variety of archiving, supervision, eDiscovery, and analytics services. The rationale: *"the acquisition will allow Zix to deliver gold standard solutions for archiving and compliance. This acquisition expands Zix's cloud-based email archiving capabilities into more than 50 content channels, including social media, instant message, mobile, web, audio, and video. Zix also believes the acquisition will strengthen its relationship with financial services and legal customers by allowing it to offer a more comprehensive archiving solution that helps customers comply with industry regulations."*

The acquisition looks a little pricey to me; per the 8-K, "Erado achieved 2017 revenues of approximately $3 million dollars, which was an increase of more than 20% from 2016." The acquisition is expected to contribute $1.5MM under Zix's ownership in 2018 - similar to the Greenview acquisition, weird purchase accounting probably leads to it being understated - and it's expected to be OCF neutral and net income negative, thanks to dumb fake intangibles amortization. ~5x revenue seems a little high, although given Zix's balance sheet, their ability to incrementally utilize DTAs, and their ability to use their broader distribution and "bundling" to potentially achieve revenue synergies, it doesn't strike me as a bet-the-farm type investment, nor one likely to destroy much value - in fact, thanks to the DTAs, it should recoup most or all of the purchase price as FCF within a year.

Given that my model is EBITDA-based and it's not clear what the EBITDA characteristics are, I don't really know how to update my model for this. If I assumed my fair value on ZIXI remained the same on an EV/Revenue basis, then it would be marginally negative, more or less offset by compounding in fair value since last time, so I'm just not bothering.

As it stands today, ZIXI doesn't appear to trade at an unreasonable valuation relative to its NOPAT / EBITDA, and I'm also docking those numbers for stock-based compensation (which most technology investors don't), and I properly NPV the deferred tax asset (versus some investors I've seen simply pretending reported FCF is sustainable). Referring again to my chart of historically EV/Revenue valuation, ZIXI has routinely traded higher than the current ~3.1x current-year revenue, and I don't think prospects for the business today are that much worse than they've been at any point over the past decade - Office 365 is certainly a risk, but one that I view as mostly transitory and self-correcting.

Given how much stock I've sold already, ZIXI will have been a success even if it retraces all the way back to $4, so I'm trying to remain patient and realize that if either fundamentals (or the market) exceed my reasonably conservative expectations, the stock could end up even higher. I'm not betting on that, but even if the stock doesn't gain any more ground over the next year, I'll gain after-tax value by sitting on it.

We'll see what happens…

2018-05-02: Zix Q1 2018 Earnings (I'm Out)

Date Today: 2018-05-02

Position Size Today: none practically (1-share bookmark to remind myself to keep track of it for decision journaling purposes)

Price Today: $5.32 / $247MM EV / ~20.5x NOPAT / ~13.4x EBITDA (pro forma for ~$1.7MM of unrecognized Erado revenue)

Fair Value Estimate Today: ~$4.80 /$220MM EV / ~18x NOPAT / ~12x EBITDA (pro forma for ~$1.7MM of unrecognized Erado revenue)

Date Last Time: 2018-04-20

Price Last Time: $5.00 / 18.5x NOPAT / 12.1x EBITDA / 3.1x Revenue / $210MM EV

Fair Value Estimate Last Time: same as last time - $4.76 / 17.5x NOPAT / 11.4x EBITDA (implies $199MM fair EV today)

Position Size Last Time: ~120 bps (sold roughly two-thirds of original shares)

Reason for Update: ZIXI Q1 earnings (sold all shares prior)

BLUF: I sold all my shares before earnings on the further move about $5 and don't regret it… Zix was a "business with a price" for me, and I got my price (and then a bit), so I'm happy.

Action Items: None… continue to check in from time to time for decision-journaling purposes (i.e., to see whether or not my fundamental analysis ends up being borne out, notwithstanding the rapid stock price reversion on pretty much no news, which can hardly count as fundamental validation of my investment.)

Explanation: Sometimes value investing can feel like a painful struggle… sometimes it feels too easy. Zix (ZIXI) was the latter; usually I'm guilty of buying too much too early. In the case of Zix, I almost literally bottom-ticked it (my basis was $3.94-ish), and the stock pretty much did nothing but go up and to the right for two months:

Hindsight bias is 20/20 and it would've been nice to have more Zix, but I'm pretty happy with what I had. Q1 suggests that things are more or less playing out the way I expected them to, with the caveat that A: it's one quarter, and B: the company *did* do a nontrivial acquisition that very modestly lowers my fair value (but certainly could be quite strategic).

Overall, my fair value on ZIXI doesn't change much, sticking in the high $4s; the current stock price certainly isn't indefensible (particularly given that I ding the company fully for stock comp and most tech investors don't), but I got what I came for and I don't know enough about the competitive landscape here to have any interest in playing this for the "risky" gains.

--

The company's acquisition of Erado was a continuation of their bundling strategy, which per various commentary, seems to continue to go well. The company also sounds like it's basically given up hope on the Cisco/Google partnerships, but sees a lot of promise with its "single pane of glass" MSP initiative:

> *ZixProtect and ZixArchive are continuing their impressive momentum from 2017 generating meaningful competitive displacements. Our cross-selling initiatives are delivering as planned, and the market is responding favorably to our positioning.*
>
> *With our recent addition of Erado, we have advanced our bundles to meet the absolute gold standard and compliance when it comes to protecting and archiving business communications.*

Our existing cloud-based solution is now bolstered by unified archiving and supervision capabilities that are best-in-class for compliance focused buyers.

So we're now in an even stronger position to meet our customers needs. Our leadership position is strengthened beyond e-mail to all forms of digital communications, including social media, instant messaging, mobile, web, audio and video. We are also welcoming a large customer base of 18,000 customers across the financial services vertical whole, who we can continue servicing with best-in-class archiving solutions that they're already familiar with and also, provide added value to our bundled offerings and complete e-mail security solutions.

The result is, one, a happy customer because they are better able to efficiently comply with FINRA and SEC regulations; two, a robust and complete e-mail security solutions because we're able to combine these archiving solutions with our e-mail encryption and advanced threat protection offerings; and three, a platform for continued growth as we work to solidify our status as one of the preferred choices for customers who must meet compliance requirements.

In addition to bolstering our solutions, we also made positive strides on the distribution front. Just shortly after the quarter ended, we announced the expansion of our MSP program, which integrates additional offerings to provide best-in-class security for our partners. As we mentioned on our previous call, we're focusing more on distributor relationships that can drive the most value for us and our customers. So strengthening the MSP program and giving our valued partners more flexible options and a path to growing their businesses more successfully is high on our priority list.

[...]

Our April launch of our new Zix partner MSP program is a perfect example of our plans to improve our distribution. The new program is a major step forward for MSPs and will help us attract new partners to the program for continued growth.

At a very high level, the program provides MSPs with the ability to sell and administer e-mail threat protection and e-mail archiving, in addition to our existing e-mail encryption offering.

The program offers MSPs flexible billing, rapid deployment and a centralize management console for administration of all of our solutions.

[...]

As a result of these changes, beginning on the Q2 earnings call, we will no longer be reporting Cisco and Google as OEM channels, and we will bundle the remaining immaterial OEM partner orders into a new category of web sales and other. We do not expect any meaningful impact to this year's new first year orders or revenues from these relationship transitions, although we do think that both transitions will be positive for our end customers, our resellers and Zix.

[...]

Lastly, before we open the call for questions, I'd like to spend a moment on our acquisition of Erado, which was announced in early April. We are very excited about the acquisition as it

> *expands our cloud-based e-mail archiving capabilities into more than 50 digital communication content channels and add strong supervisory capabilities for compliance officers to monitor and review all of the organization's business communications from one centralized uniformly indexed set of content.*
>
> *More than 50% of Erado's revenue comes from archiving channels other than e-mail, with LinkedIn being by far the most important channel other than e-mail.*
>
> *Many businesses with compliance requirements are moving to LinkedIn and other social channels to prospect and to communicate with customers. The unified archiving capabilities are a perfect fit for our compliance-oriented customers in health care, finance and government sectors. And the addition of the Erado customers to the Zix family makes us even stronger in financial services.*
>
> *We see a very strong opportunity for Erado capability in the market. And as we integrate, we will be focusing on 2 areas: first, accelerating the current market momentum in a broker-dealer and financial services space. Like most IT services, archiving is transitioning to the cloud and they're the large installed base of on-premise legacy capability that is right for disruption. We are investing immediately in more go-to-market capability to support the existing team in Seattle and to grow our market presence in the broker-dealer segment.*
>
> *The second focus area is integrating the additional data channels and supervisory capability into our core ZixArchive product on the ZixCentral platform.*
>
> *One of the reasons we selected Erado is that their 100% cloud-based architecture is consistent with our platform architecture, and we expect to be able to integrate the majority of the functionality into a good, better, best set of archiving packages that we can position strongly to the existing Zix installed base and through our MSP and VAR partners.*
>
> *The planning work for this integration is well underway, and we expect to have integration completed before year-end.*

The Erado acquisition makes complete strategic sense. They did pay ~5x revenues for it, which seems high relative to the growth rate (20%) and the conceivable EBITDA (~16x multiple if it has Zix-like margins). That said, I also recognize that it's a strategic imperative for Zix to maintain its best-of-breed status, and that it has the distribution network to meaningfully cross-sell, so if I were remaining a shareholder (which I'm not), I wouldn't view the acquisition as wildly destructive.

Acquiring a company that has a good product in monitoring social media / non-email communications seems like a very sensible move for Zix and, in some sense, a hedge (since their technology platform will now be extensible to other channels of communication, if the business world moves to Slack or LinkedIn or, I dunno, Snapchat, for critical customer communications. I'm being somewhat sarcastic but this was always one of the "risks" with Zix.)

From a financial perspective, not a lot of surprises: Adj. EBITDA margins were 29%, guidance is being raised by the amount of revenue they expect to recognize from Erado, and they're not going on any wild capex spending sprees. They did buy back about $3MM worth of stock but they buy back stock always and everywhere, so it's not that impressive.

> *And finally, our adjusted EBITDA for Q1 2018 totaled $4.8 million, an increase of 8.4% compared to $4.5 million we reported in Q1 of last year.*
>
> *As a percentage of total revenue, adjusted EBITDA for Q1 was 29%, which was higher than the same quarter last year and consistent with a 29% we reported last quarter.*
>
> *[...]*
>
> *Under the current program, we are authorized to purchase an additional $3.1 million worth of shares as of April 1, 2018 subject to certain conditions. In fact, we continue to repurchase shares during April of this year. While we continue to invest in our solutions to better serve the compliance-oriented and security-driven customers in the midmarket segment, we are reiterating our commitment to a balanced capital allocation strategy.*
>
> *Over the last 27 months, we have demonstrated this balance by purchasing $19.2 million of our stock and used approximately $20 million for acquisitions. The mindset of deploying capital in the areas where we see highest returns will be what guides us as we look to continue increasing shareholder value.*
>
> *CapEx for the quarter was $546,000, which consisted primarily of normal business capital purchases. We continue to expect CapEx for 2018 to be between $2.3 million and $2.7 million and for depreciation to be approximately $2.7 million*
>
> *[...]*
>
> *Now for our second quarter and full year 2018 financial guidance. Because of the acquisition of Erado in April, we are updating our guidance for the quarter and full year. As we disclosed earlier this month, for the full year of 2018, we expect subscription revenue from the acquisition to contribute $1.5 million and expect operating cash flow to be neutral, but expect net income and EBITDA to decrease approximately $1 million due primarily to an anticipated purchase accounting adjustment to deferred revenues*
>
> *We expect revenue for the full year range to be between $69 million and $70.5 million, which represents an increase of 5% to 7% compared to revenue in fiscal 2017.*
>
> *Our previous guidance for revenue range between $67.5 million and $69 million. The only adjustment being adding the $1.5 million of revenue for the Erado acquisition.*

It also seems like - again, with the caveat that it's just one quarter - the company is doing a good job of working through the retention issues that drove the stock down.

The third and final growth area we're focused on is reducing churn and increasing retention. I'm pleased to report that our retention is gradually improving and that we were solidly above 90% in the quarter and that we achieved the second highest quarterly retention rate since 2016.

We continue to get in front of our on-premise appliance customers. Total ACV from on-premise appliance customers decreased from 20% and 19% of ACV in the quarter. We can't stress enough how important it is that we migrate our on-premise customers to the cloud because that's where they become stickier and where they can most easily take advantage of a complete product suite.

During Q1, we successfully migrated 200 customers to our hosted platform and an additional 30 from Google game to our multitenant cloud. It's very encouraging to see the pace at which our customers are moving to our multitenant cloud solutions. And during Q1, we reached the point where just over 50% of our ACV is from customers who are 100% cloud deployed.

So as a result, retention is improving, both in the quarter and on a rolling 12-month basis. Going forward, excluding the last part of the 2017 excess churn that we expect to work through this quarter, we expect our renewal rates to stabilize at a new normal.

ZixProtect and ZixArchive are no longer new products, but our products with hundreds of reference customers allowing us to position a strong bundle for our existing customers as well as new prospects. This success combined with success we are having migrating customers from on-premise, both appliance and virtual to our cloud, has us increasingly confident that the retention drag will subside.

However, the new normal on the cloud-based bundle means that we do not expect to return to the record high retention rates we saw in 2016 for some time.

[...]

Eric Anthony Des Lauriers, Craig-Hallum Capital Group LLC, Research Division - Associate Analyst [2]

This is Eric on for Mike. I was wondering if we could just drill in a little bit more into churn and retention. I know you've talked a lot about it. But could you just give us a sense of the new normal level? And how that relate -- how that compares to what the previous level was?

David J. Wagner, Zix Corporation - CEO, President and Director [3]

Yes. So what we're talking about is, anyway, has been consistent is over 90%, is what we achieved last year and expect to continue to achieve. But 2016 was an exceptionally strong year, we were several hundred basis points above that. And given the shortening term contracts in the market space and the lack of stickiness or the less stickiness in the advanced threat space, we think will be in the low-90s opposed to mid-90s as our new normal.

I don't think there's much more for me to do here except to continue to monitor the company occasionally to see if my fundamental thesis ends up being proven out (since, again, the "win" here has to be considered pure luck instead of skill.)

If ZIXI fell back into the low $4s, I'd probably consider taking a position again, but above $5, I would need to have a lot more conviction in the strength of the product in its niche. ZIXI could very well be worth well into the $5s, or even above $6, if they can generate high single digit revenue growth or get themselves bought by some larger company, but that's not my strategy, and ZIXI could just as easily (on the basis of my knowledge) be worth the mid-$4s or perhaps less, if their space is tapped out and they face increasing competition from bigger players and/or need to "invest" in technology acquisitions like Erado that are strategically important but financially non-accretive (if those acquisitions were needed to maintain, rather than to improve, the business.)

Finally, it does bear noting around the edges that while the company believes the more frequent touchpoints of annually recurring revenue are superior to 3-year contracts, that does also mean that in a downturn, they might see a little more pressure than they otherwise would have. Considering it's still annual recurring revenue and that much of their product is compliance-driven, it's not a huge risk… maybe just wishful thinking that I'll be able to buy this again someday, because I do think it's a neat/serviceable little business at the right price, and I have yet to see any evidence that management is bad (other than the pretty-standard "we buy shares at all prices,") which is a reflexive problem that's irrelevant when the stock is cheap anyway.

On to the next one…