Vocera Communications (VCRA)

Date	5/24/16	Cash	$120m	Recommendation	BUY
Stock Price	$11	Cons Rev Growth %	30%	Fiscal Year -End	Dec
Market Cap	$290m	FY16E EV/S	1.6x	Short Interest	6.5%
FY16E Rev	$115	FY17E EV/s	1.4x	Analyst	NOD
FY17E Rev	$127.5				

Thesis: Hospitals in the US have completed installing EHR/EMR software solutions that the Government had incentivized them to do by late 2014/early 2015 (they had received money under the HITECH Act). During this installation, Vocera had to serially guide down sales numbers (it did so in 2013 and 2014) and likely lead to loss of credibility. The first big drop in the stock price was May 2013, when it reduced sales guidance from $120-130m to $100-110m. The issue was that much of 2013 and 2014 were littered w ith starts and stops, leading to a withering share price. It has posted 3 quarters of revenue growth, deferred revenue growth has accelerated and backlog has shown strong growth for 1.5 years. The main difference appears to be hospital spending that was fo cused on EMR/EHR has ended, and is now shifting to other areas - and communications appears to be one of them (others being patient surveys, outpatient centers, population health). More recently, the company has signed many large deals, 7 make up 33% of th e backlog and many momentum investors had bet on these wins being recognized quickly - the reality is that the sales will be recognized over 2 years. This appears to be the main driver of the pullback in 2015. I think management will raise revenue guidance for 2016 during the 2q16 call as it continues the implementations as it has better revenue visibility with the larger deal wins - that is a major reason why I think we should take a position.

Sales grew 9% in 2015 and I see 13% growth in 2016 and 2017 (aided by all -time high backlog and deferred revenues). The firm will limit operating expense growth (down 5.7% in 2015, up 4% in 2016 and 7.5% in 2017). Combined, this will mean positive operatin g cash flow in 2016 (it was flat in 2015). Further, the company has $120m in cash it can use for add -on acquisitions to propel growth further and build scale.

Vocera provides communication tools to hospitals (95% of revenue) and other industries - software (and future maintenance) platform, communication device (badge, phone), and professional services. It is currently used in 1,400 facilities around the world: 980 US hospitals, 170 International hospitals (mostly English speaking nations - UK, Australia, New Zealand, but also Malaysia and the Middle East). International currently represents 9% of sales, but they believe this could grow to 20% over the next 3 to 5 years.

The badges are worn by many hospital employees, including nurses, doctors, cleaning staff, security, basically anyone who needs to be in the loop. All the devices work as long as there is wi-fi connectivity. The software platform can integrate with clinical systems in the hospital (Cerner, Epic, Allscripts, other), some of the machines that send alerts (heart rate, oxygen,...) and push that data to phones or the badges. VCRA has apps for iPhone and Android, re-sells Zebra rugged phones --> this can improve patient safety and better utilize hospital staff.

Revenue recognition : It sells "perpetual" license to software, along with maintenance revenue. The software revenue (around 15% of total sales) is recognized after installation, the maintenance (now 35% of sales, and is "recurring" with 95% existing customer renewal rates) is recognized over the life of the contract. It also has professional services for smooth installation.

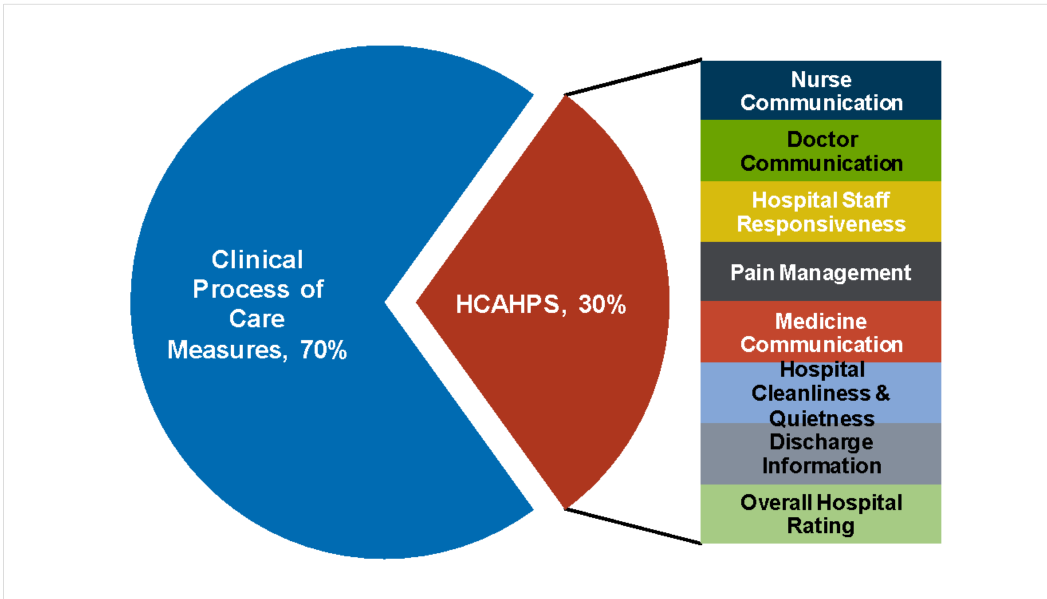
It then sells the hardware - badges, batteries, chargers, accessories, Zebra rugged phones. These sales are recognized on delivery. It outsources the manufacturing of badges to SMTC corp, and needs to give them 6 month orders, so there is some inventory risk.

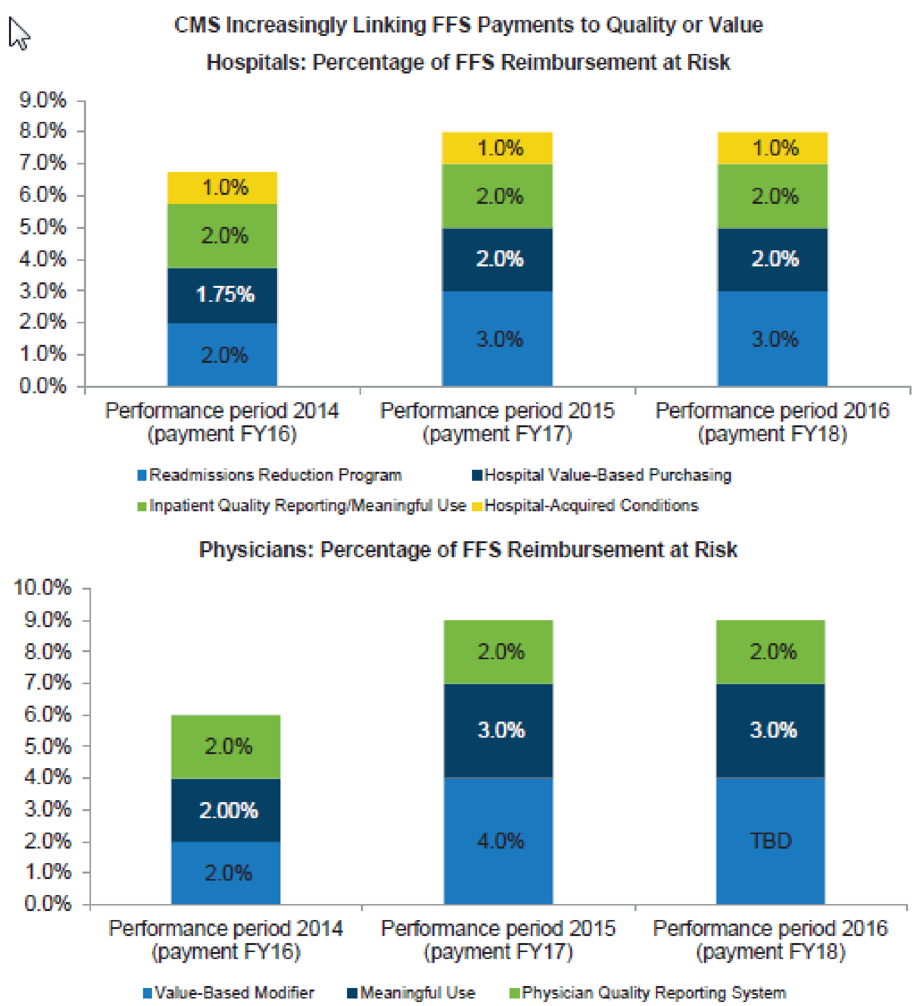
We've asked management on why they do not do a "recurring/ SaaS" type model where it would just charge per badge or per user and they said they've tried it with some hospitals (and some do utilize a leasing model) but hospitals are too used to buying things all-in: they buy EHR (Cerner, Epic) as perpetual + maintenance + professional installation, but devices/drugs as needed + some inventory, they even buy nurses and docs from staffing as needed. So, the business model that VCRA uses is "as good as it will get", but we need to recognize that it is NOT a good one, just what it has to operate.

Cost of revenue : Software margins likely 85%-90% or better, Maintentance around 65% or so, professional services maybe 25-30%, hardware margins around 55%-60%. If it re-sells more of the Zebra phones, product margins will go down (as it would be mostly sell-through). It has been selling more software add-ons to the existing installed base, which would help margins over the next 2-3 years.

Market : There are around 5,000 hospitals in the US, Vocera has 980, so less than 20% penetrated, so there is plenty of runway for low-double-digit revenue growth (especially when you include the growing base of maintenance revenue). The bulk of its US hospital customer base is nonprofits: 2,870 of 5,000 (or 60%) of the US hospitals are nonprofits, according to American Hospital Association. .

Why should hospitals buy? Reimbursement tied to survey outcomes (2% of total amount at risk, in the second chart below). Vocera could IMPROVE the outcomes of surveys by improving communications between care providers (nurses, doctors, pharmacists, techs) and patients. (Press Ganey does surveys like HCAPHS listed below).





Source: CMS

Hospital/Health System Consolidation : Oddly, VCRA says that consolidation is HELPING business as larger health systems are looking at communication as productivity enhancement tool versus a cost. VCRA solutions work across facilities, as long as they are all on the same IT system, so this he lps sell large installations across multiple locations.

Competition : It is really replacing existing pager, overhead paging/announcement, and hardwire phone technologies. The competition is convincing customers to move to a new platform, and early on this was a "missionary sale" for sure, but the focus within hospitals and health systems has changed and the sales process is becoming easier, though still takes >12 months to close a deal.

Key Risks:

Implementation of large customer wins: If there are issues, it will be forced to reduce revenue guidance, and remain in the credibility penalty box, limiting share price appreciation.

EHR/EMR re-installs: CMS will be asking health care providers for proof that existing systems are doing what they expect (known as "meaningful use" guidelines). We know that hospitals and other facilities installed "bad" solutions and will be forced to install ones that actually work, I don't have a good estimate for the number of these, but I do worry that it could hurt Vocera ability to sell to those customers needing reinstallation.