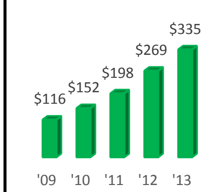
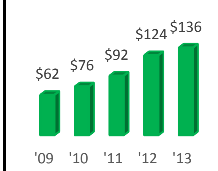
Solarwinds
October 16, 2014

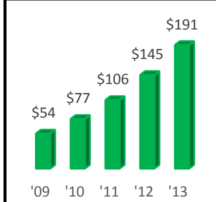
General Overview

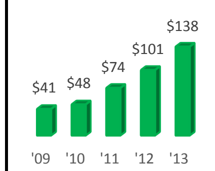
Solarwinds Inc. (SWI) is a software development company headquartered in Austin, Texas. The company sells enterprise-class IT infrastructure management software to IT professionals in organizations of all sizes.[1] SWI serves over 95,000 customers in more than 180 different countries; including small businesses, governments and more than 450 of the Fortune 500 companies.[2] The company's products lead the industry for quality, ease of implementation, and total cost of ownership.

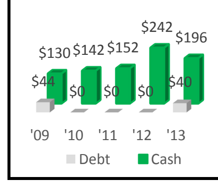
Revenue	License Revenue	Maintenance Revenue	Owner Earnings	Balance Sheet
$335,385,000	$135,839,000	$191,491,000	$137,627,420	Cash = $196,312,000
5-Year CAGR = 30.3%	5-Year CAGR = 21.5%	5-Year CAGR = 37.2%	5-Year CAGR = 35.4%	Debt = $40,000,000











Purchase Logic

We acquired our stake in SWI at approximately 16x earnings with an average purchase price of $39.90 per share. The logic behind our purchase of SWI was relatively simple: We paid a fair price for an outstanding company. The S&P 500 presently trades at an average price multiple of 16x earnings and SWI is vastly superior to the average constituent of the index. The company has been compounding owner earnings at a rate of 35.4% for the last five years and the competitive advantages that have allowed SWI such robust success remain intact.

Future Expectations

The price of SWI is relatively volatile due to the rapid growth of the business. The stock moves significantly with slight changes in the year-over-year growth rate of new license sales – a leading indicator of future growth. New license sales naturally fluctuate and we fully anticipate future time periods when new license sales growth is slower or even negative. The stock price would likely be impacted negatively in such an event and our intention is to purchase more during such time periods. We also anticipate periods in the future when new license sales growth exceeds expectations. In such an event the stock price may rise disproportionately as analysts update models to reflect the 'higher' growth. Due to the dominant market position and outstanding growth of the underlying business we may not sell our position under these conditions. It is extremely difficult to find businesses with such strong prospects for growth. A long holding period has a high probability of compounding our wealth more significantly than taking short-term gains.

1 Solarwinds Inc. 2013 10-K
2 Solarwinds Inc. Investor Relations

Financial Highlights

Historical Growth

In the last 5 years SWI has managed annual top line growth of 30.3% which has translated into a CAGR of 35.4% for owner earnings. New license sales, the leading indicator for future growth of the business, have continued to climb in the most recent quarter at a rate of 21%. There are presently no headwinds affecting the growth of the business.

Table 1: Performance Measures

Year	1H2014	2013	2012	2011	2010	2009	2008
Total Revenue	$197,413,000	$335,385,000	$268,964,000	$198,358,000	$152,393,000	$116,446,000	$93,135,000
License Revenue	$73,987,000	$135,839,000	$123,984,000	$92,254,000	$75,603,000	$62,378,000	$55,461,000
Maintenance Revenue	$112,956,000	$191,491,000	$144,980,000	$106,104,000	$76,790,000	$54,068,000	$37,674,000
Gross Profit	$176,487,000	$307,469,000	$250,564,000	$186,369,000	$144,463,000	$111,586,000	$89,547,000
Owner Earnings	$74,745,000	$137,627,420	$101,420,915	$73,620,417	$48,024,853	$40,957,727	$25,576,265
YOY Earnings Growth	24%	36%	38%	53%	17%	60%	-
Cash	$207,272,000	$196,312,000	$241,801,000	$152,395,000	$142,003,000	$129,788,000	$40,566,000
Debt	$40,000,000	$40,000,000	$0	$0	$0	$44,097,000	$101,118,000

Balance Sheet

SWI typically operates with no debt, but occasionally taps credit markets to execute larger acquisitions. The firm executed two acquisitions in 2013 acquiring Confio ($103 million) and N-able ($127.7 million) for total compensation of $230.7 million. In order to complete these transactions the company borrowed $40 million on a revolving line of credit. Management announced their intention to pay off the $40 million dollar balance by the close of the 2014. SWI generates ample free cash flow to continue operating with no debt. The company current holds more than $200 million in cash that is available for future acquisitions.

Future Performance

It is our expectation that SWI will continue to grow owner earnings at a rate in excess of 15% for the next 10 years. We anticipate periods of performance that both exceed and lag this long-term growth rate. As we continue to monitor this investment we will focus primarily on industry conditions and the quality of the company's competitive position.

Favorable Industry Conditions

Businesses that maintain IT infrastructure, such as SWI, have enjoyed large profits for a relatively long period of time. We believe that this trend will continue due to the unique position that IT solutions have in the enterprise – they are vitally important. Fortune 500 companies from Apple to Walmart rely heavily on their data center and communication platforms. Processes globally are being automated and digitized to reduce the amount of labor that is required to complete tasks. These cost savings are realized through complex IT solutions. If these IT solutions are unavailable, even for short durations of time, the lost revenue and damage to a business's reputation can be costly. For example, in the last 90 days Amazon generated $116,000 in sales per ***minute*** – demonstrating the high opportunity cost of down time for their network.

Due to the importance of IT solutions enterprises typically hire multiple vendors, such as SWI, to monitor their network. The cost incurred paying these vendors is low relative to the potential downside of a network outage. In other words - the value of the asset being insured is far greater than the cost to insure it. This helps contribute to the high renewal rates on maintenance contracts, typically in excess of 90%, for the majority of the industry.

The importance of IT infrastructure extends beyond large enterprises and governments – even small businesses rely on their networks. A small dental office may generate revenue of more than $5 million per year. This small office likely operates on a network that allows access to patient files, dental records, scheduling, billing, and more. If the network goes down for a single afternoon the opportunity cost is very high. This demonstrates that businesses around the world, both large and small, are becoming increasingly dependent on functioning networks. The market opportunity for the service SWI provides is large and continuing to grow.

Finally, the industry benefits from high switching costs. Implementing a network monitoring solution is expensive relative to the annual maintenance costs. The implementation costs exceed annual costs for several reasons; including sales commissions and labor for installation. This creates a competitive moat around a company's portfolio of existing clients. When competitors attempt to steal market share the implementation costs typically make it uneconomical to switch providers. This allows incumbents to enjoy high retention rates and strong recurring revenue.

Strong Competitive Position

SWI is positioned as an industry leader with a focus on three areas: Quality, Ease of Implementation, and Total Cost of Ownership.

<u>Quality</u>

SWI products have lead the industry for quality for several years. This is objectively measured by large gains in market share and a growing list of industry accolades. Awards range from #1 on the list of Forbes fastest growing companies to winning every category at the IT Brand Pulse Awards in 2014; including Market, Price, Performance, Reliability, Service & Support, and Innovation. SWI benefits from a highly involved community of IT pros that share ideas, feedback, and tips at SWI's online forum: https://thwack.solarwinds.com/welcome. With more than 150,000 registered IT pros the website is a hot spot for networking solutions and an invaluable source of customer feedback for SWI development teams. The tight engagement with customers helps SWI lead the industry for quality.

<u>Ease of Implementation</u>

SWI develops products that can be downloaded for free, installed easily, and are fully operational with a few hours. The free download grants access to the networking monitoring software for one month. Utilizing this model an IT professional with a network problem is able to solve their problem quickly via an internet download with no out of pocket expense. At the end of the one month free trial SWI is able to call a satisfied IT professional and ask if they are interested in purchasing the software. This sales model is known as 'selling from the inside' and significantly reduces customer acquisitions costs for SWI when compared to competitors. The typical upfront cost for implementation of SWI's software solutions is $7,900.

Total Cost of Ownership

Total cost of ownership is the sum of all expenses required to annually operate a network monitoring solution. This includes initial implementation, annual maintenance fees, salaries and wages for support personnel, and the purchase price of software packages. In this area SWI is a clear market leader. The company compares their business model to that of a generic drug company. The business takes very little risk, allows larger competitors to innovate by spending large amounts on R&D, and then intentionally provides competing solutions at a fraction of the cost. This approach has allowed SWI to release competing products to the IT community that are more easily implemented, require less technical sophistication, and save significantly on total cost of ownership.

Risks

We view SWI as a very low risk investment. The company operates in an exceptionally profitable industry and has a very strong value proposition for customers. The customer base is fractured with more than 95,000 small and mid-size business, enterprises, and governments that collectively have retention rates in excess of 90% on annual maintenance contracts. The diverse customer base and strong retention levels create predictable and stable earnings. Below we highlight some short-term risks that may occur and would likely have a negative impact on the price performance of the stock in the short-term.

Short-Term Risks

- Changes to Google's search algorithm. SWI generates customer leads through paid search advertising on Google. If Google were to change their algorithm it has the potential to impact SWI's lead generation and would directly impact new license sales. A decrease in new license sales would likely negatively impact the stock price in the short term. We are confident SWI would be able to make adjustments to the company's search engine optimization (SEO) and continue to drive strong leads through paid search.
    - Low Risk
- The company loses their largest distributor / contracts with the United States government. These contracts account for less than 10% of the revenue and profits for the company. In the event that this contract is lost it would take approximately 4 months to replace the lost revenue and profitability at current growth rates.
    - Low Risk

Long-Term Risks

- Technological Obsolescence. It is possible that advances in networking hardware would increase reliability and reduce the necessity for monitoring software. We believe this type of obsolescence is remote. As networks continue to advance individuals and businesses will demand higher performance and increased complexity. Additionally, as the workload performed by IT centers globally increases the opportunity cost associated with a network failure will continue to compound.
    - Moderate Risk
- Complacency. The efficiency and outstanding product development created by SWI business model could slowly deteriorate over time. This would cause the business to lose its position as the lowest cost provider and fastest growing player.
    - Unavoidable Risk
- Few Physical Assets. SWI is a software company that derives the majority of its market value from the earning power of the business' software solutions. In the event that new license sales decline and the product becomes obsolete there is very little owner equity available to set a price floor.
    - Moderate Risk

Growth Opportunity

The ease of installation and low price point has allowed SWI to target a larger potential client base than their competition. The business currently serves less than 1% of the 11 million small to mid-size businesses globally. The total addressable market is exceptionally large and the runway for growth is long. The company has recently completing translating the website and sales process into multiple languages for global distribution.

No significant changes are required to the business model to maintain the phenomenal growth rate. The business is scalable and requires repeated execution of the same sales system and development cycles that have accounted for growth historically. We fully anticipate competition to intensify and for the successful model of SWI to be duplicated, but the industry is sufficiently large that many companies will be able to achieve wonderful results (similar to banking). It is our expectation that SWI will continue to grow at more than 15% per year for the next 10 years.

Moat

The company's economic moat is protected by the combined effect of the following three contributing factors:

1) High Implementation Costs (Industry Specific)

Regardless of the solution provider the implementation cost of a new solution is typically 4 or 5 times greater than the recurring annual cost. The high implementation cost relative to the annual cost make it uneconomical from a discounted cash flow analysis to switch providers. This contributes to the exceptionally high retention rates for maintenance revenue industry wide. The small to mid-size businesses are presently under served and represent a greenfield opportunity for the industry. The customers that SWI wins during the land grab will be loyal for many years.

2) Brand Name & Critical Function (Company & Industry Specific)

Monitoring the IT infrastructure is a critical function for many businesses. When considering a service provider for this critical role many business owners are swayed by 'social proof'. If 95,000 small businesses are satisfied with SWI's products then it is natural for a business owner to avoid risk and select the same product. The strong brand name centered on a critical function helps SWI continue to win additional business.

3) Low Cost Provider (Company Specific)

SWI is currently the lowest cost provider in the IT infrastructure space. The company has secured this position through outstanding management, targeted R&D, and a unique sales method that is extremely cost effective. As the company scales they are able to lower their price point while maintaining exceptionally high levels of profitability. This is due to the scalable nature of the software industry as a whole. It should be noted that SWI could potentially lose their position as the lowest cost provider but still enjoy a successful decade and meet all our performance expectations.

Conclusion

Solarwinds (SWI) is a rapidly growing business with growth in excess of 30% for the last 5-years. The industry and competitive conditions that have allowed such robust growth are unchanged. The total addressable market is large and SWI has less than 1% market share. We paid a fair price, 16x earnings, for a business that is performing significantly better than the average S&P 500 constituent. Our expectation is for the business to continue compounding owner earnings at a rate in excess of 15% for the next 10 years. We believe this earnings forecast has a high probability of realization and low risk due to the economic moat surrounding the business. This economic moat is built on three contributing factors: high implementation costs, strong brand name centered on a critical function, and the position as a low cost provider. Due to the high probability of prolonged growth we believe that a longer holding period would more effectively compound wealth.

Works Cited

1) Solarwinds Inc. *Annual Report - SEC Filing 10-K*. EDGAR, 2013.
2) Solarwinds Inc. *Company Webiste – Investor Relations FAQ*. http://www.solarwinds.com/ir/investor-faq/, 2014.

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