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TRADER EXTRA

# Demandware's Danger

*Demandware is as sexy as BB&T is boring. What the e-commerce company lacks—after nearly a decade in business—are profits.*

By VITO J. RACANELLI
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Demandware (DWRE) is as sexy as BB&T is boring. The Burlington, Mass.-based company sells cloud-based services to retailers and consumer-brands companies, for the most part. Its products and software are used by companies to develop and manage e-commerce across various platforms, including online, in-store, mobile, and social networking.

E-commerce sales are expected to grow about 20% annually through 2018. Demandware, whose products are well respected, is growing faster yet, with annual revenue up an average of 50% over the last five years, to $160 million in 2014 from $21 million.

What Demandware lacks, however, after nearly a decade in business and three as a publicly traded company, are profits, though analysts forecast $8.6 million next year. Investors should beware all the same. Even after falling from $76 in July to a recent $52.17, shares trade at a sky-high 233 times projected earnings.

Losses have widened steadily, to 78 cents per share last year from 23 cents per share in 2012. The first half of 2015 has been no better, with a loss of 71 cents versus 49 cents in the year-ago period. The figures are based on generally accepted accounting principles.

And Wall Street's 2015 projections seem optimistic, given they have consistently proved too bullish since the company came public at $16 in March 2012. There's no reason to think the profit-poor situation has changed. Moreover, the consensus uses adjusted non-GAAP EPS, leaving out various noncash expenses, such as stock-based compensation packages, which are substantial at Demandware. That's common enough for high-tech companies, but these compensation costs aren't going to let up any time soon. As of Dec. 31, there was another $62 million in yet-to-be-recognized stock compensation due over the next three years.

Demandware's other expenses are lately outpacing sales. In the second quarter, subscription sales rose a blistering 45% from a year ago, but costs grew at a 60% clip.

Demandware gets the great majority of its revenue based on a subscription model, taking a small percentage of customer sales over its platforms. It relies heavily on its ability to add new clients and create new services to further integrate clients into its system. But attracting new customers and developing new features has been increasingly expensive for Demandware, says David Trainer, president of New Constructs, an independent accounting research firm.

The market eventually wants profits, but given intensifying competition, it's hard to believe Demandware will generate as much as is already discounted by the high share price, says Trainer, who calls the stock significantly overvalued. Deep-pocketed rivals include IBM (IBM), Oracle (ORCL), eBay (EBAY), and SAP (SAP), among others, want a piece of this growing industry. So how would cost growth subside much? Moreover, Demandware is the lower-price alternative and has less to give on margins.

Some key metrics have slowed. Annual customer growth fell to 31% last year from 35% in 2013 and 50% in 2012. The backlog increase dropped to 37% last year from 67% in 2013. While many companies would love these numbers, the trend is going the wrong way for Demandware's valuation.

The stock is vulnerable to another quarterly miss. Part of the drop seen so far was due to a second-quarter EPS miss, when shares fell 12%. Average subscriber revenue grew 4% in the last quarter from the year-ago period, much less than the 13% average of the previous five quarters. That could mean Demandware is signing up smaller customers, or prices are eroding.

Demandware did not respond to a request for comment.

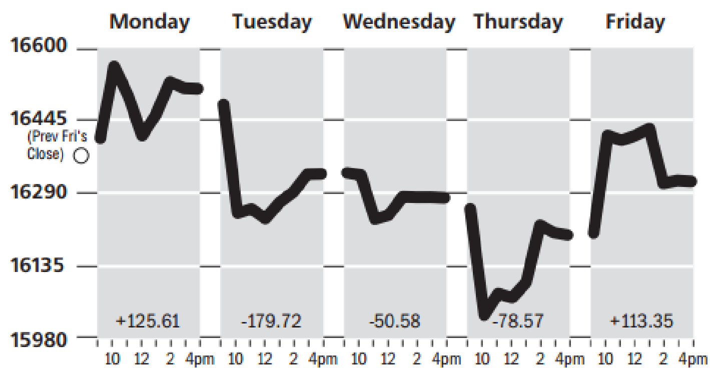
The biggest caveat to our skeptical thesis is a potential buyout. Demandware rivals have been acquired in the past two years at five-to-eight times annual sales. The market's animal spirits have dampened of late, but even if Demandware is bought at eight times its more profitable subscription revenue, that would come to less than $1.5 billion—25% below its current market value.

That a corporate buyer someday could pay through the nose for Demandware's projected EPS doesn't mean an investor should.

(See Trader: "Stocks Fall as Uncertainty Over the Fed Rises")

## FIVE-DAY DOW COMPOSITE

**How Now Dow?** The Dow rose Friday on strong Nike earnings but fell 0.4% for the week. Nike jumped 9% and P&G 4% while CAT fell 10%.




**E-mail:** vito.racanelli@barrons.com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