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ServiceNow – Tidying the Mess

Innovation cash kings of the next decade - *In this series we look at the standout companies that are 'pivoting to profit' and are at an inflection point of converting customer-driven innovation into shareholder value. In the next of this series, we take a closer look at ServiceNow.*

The business-facing technology company ServiceNow may be less celebrated than the consumer giants of Apple, Google and Amazon, but its operational and share price performance over the past decade since its IPO in 2012 stands up to comparison with anyone's. During this period, ServiceNow has grown annual revenues from $200 million in 2012 to around $10 billion today and grown free cash flow per share by a very significant 50%+ a year. It has delivered shareholder returns over the decade at 32% a year. This track record takes some beating.

The first thing my teammates and I in the Liontrust Global Innovation Team look for in a company is rock solid value creation for customers. The shadowy secret of the great digital transformation of the past couple of decades is that much of the spend has not delivered a positive return on investment. But ServiceNow is turning this around and enabling businesses to achieve the long-hoped for productivity gains from digitalisation and automation. Rather than supply companies with just another piece of software to add to the pile, ServiceNow sits above the mess, organises it, stitches it all together and enables different software programmes to talk to one another.

It does this today for close to 8,000 enterprise companies, including 85% of the Fortune 500 such as the likes of Walmart, CVS, AT&T and JP Morgan. An independent study by the market intelligence firm IDC in 2021 (*ServiceNow Knowledge 2023: AI Advancements Lead Customer and Partner Opportunities for Collapsing the IT and Business Divide*) of a sample of ServiceNow clients found that the average return on investment over five years was around 5-6x with an average payback period of seven and a half months.

The second characteristic we look for in a company is the ability to capture a good share of the value it creates through barriers to competition. Not only would ServiceNow's customers hate to rip it out of their technology stack but it would be an overwhelmingly painful process to do so. This is due not only to its central role in managing critical workflows across the whole business but also its supply of the technology infrastructure layer, including datacentre management and the internal software development environment. Furthermore, ServiceNow is increasingly recommended as the digital transformation solution of choice by the largest management consultants, such as Accenture and Deloitte, who have built large ServiceNow practices with significant expertise and close partnerships with ServiceNow to assist their clients with integration, with strong incentives to maintain this.

The strength of these barriers is evidenced by ServiceNow's customer retention rate of 99% and net revenue retention of 125% (above 100% through strong upselling to existing customers). This value creation and capture combination delivered at scale and with efficiency underpins ServiceNow's current annual free cash flow run rate of c$3 billion at a 30%+ free cash flow margin on that $10 billion of sales.

This is all well and good, but we have not written this article just to highlight ServiceNow's progress to date. We believe it can become one of the great cash kings for investors of the next decade. This is for three simple reasons. First, it has a huge runway for growth ahead of it and the best offering in the market. In its six largest industries its revenues are still less than 5% of the total addressable market.

Second, we believe future revenue will on average be cheaper to win than existing revenue. ServiceNow has demonstrated a strong ability to upsell to existing customers, achieving annual contract value growth within cohorts of well over 100% per year over many years (ServiceNow: Company Investor Presentation, Q2 2023). Alongside other structural scale economies such as R&D and capex leverage, this will generate operational leverage and enable free cash flow to compound faster than revenues.

Third, ServiceNow is well positioned to enable its customers to use artificial intelligence to enhance their business and achieve strong productivity gains over the coming years. Its newly announced products as part of its recent Vancouver software release – which include a large language model based copilot and text to code developer assistant (powered through its partnership with Nvidia) – have reportedly generated strong productivity gains in testing with customers, with an estimated potential 10x return on investment over time (Company management statement at Mizuho Securities *AI in Focus* Conference, September 2023), and will give ServiceNow a 60% base price subscription uplift.

While ServiceNow has never been a low multiple stock and nor should it be given its quality as a business, we believe it can compound shareholder value at 20% a year during the next five years, based on our expectation of an ongoing high rate free cash flow per share growth and reasonable assumptions about its longer-term multiple. Based on our analysis, we believe ServiceNow could generate $9 billion of free cash flow in FY2028 and we assume an enterprise value to free cash flow multiple of 30x, in line with peer averages, equating to an potential enterprise value in five years' time of around $270 billion compared with $112 billion today.

This could be considered an opportune time to be putting capital to work in high quality growing companies, with multiples reined in by 2021 and 2022's sell off and a reasonable starting point for benchmark interest rates of 5%. The companies that drive strong cash flow growth over the coming years are highly likely to deliver strong shareholder returns.

James Dowey

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Key Risks

Past performance does not predict future returns. You may get back less than you originally invested.

We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

The Funds managed by the Global Innovation Team:

- May hold overseas investments that may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of a Fund.
- May have a concentrated portfolio, i.e. hold a limited number of investments. If one of these investments falls in value this can have a greater impact on a Fund's value than if it held a larger number of investments.
- May encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings.
- Outside of normal conditions, may hold higher levels of cash which may be deposited with several credit counterparties (e.g. international banks). A credit risk arises should one or more of these counterparties be unable to return the deposited cash.
- May be exposed to Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.
- Do not guarantee a level of income.

The risks detailed above are reflective of the full range of Funds managed by the Global Innovation Team and not all of the risks listed are applicable to each individual Fund. For the risks associated with an individual Fund, please refer to its Key Investor Information Document (KIID)/PRIIP KID.