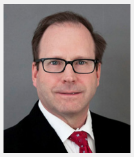
TWILIO (NYSE: TWLO)

"BUFSX team sees additional upside potential in Twilio"

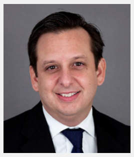
May 18, 2018 -- Twilio (NYSE: TWLO) operates a cloud-based communications platform used by developers to incorporate real-time communications into different applications. The company is considered the go-to platform for developers, with 4-5 times the developer count as their biggest peer, Nexmo, which is owned by Vonage (NYSE: VG). Twilio operates the best quality network available, with high reliability and a solid global geographic coverage unmatched by anyone else in the industry.

The Buffalo Small Cap Fund participated in Twilio's initial public offering (IPO) in 2016, but quickly exited the position as it approached what we deemed was a full valuation. Due to a lack of other high-quality tech IPOs that year, the stock went on to receive what we believe was a rather "frothy" valuation, almost 19 times forward revenue, which was well above the average high-growth software-as-a-service (SaaS) peer multiple. This valuation attracted short sellers who believed the company provided a commodity service where pricing was going to drop precipitously with additional competition, causing gross margins to collapse.

BUFFALO SMALL CAP FUND MANAGEMENT TEAM



Bob Male, CFA
Portfolio Manager



Jamie Cuellar, CFA
Portfolio Manager

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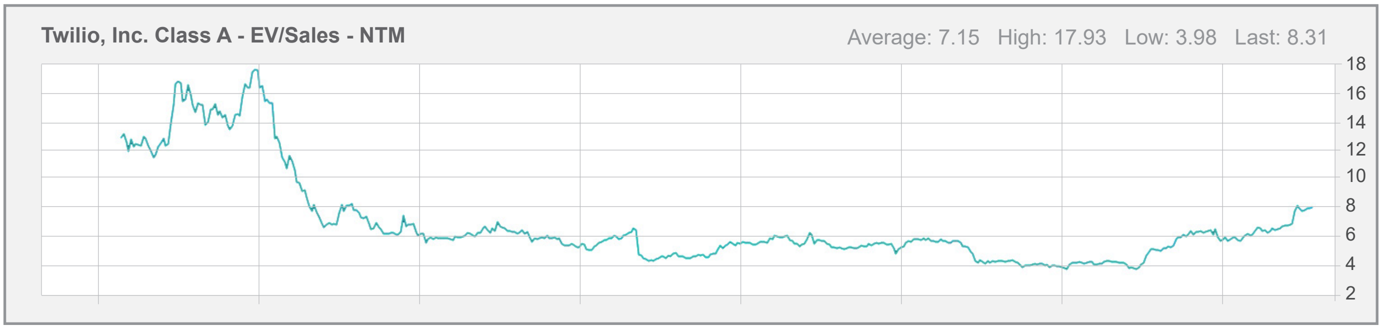
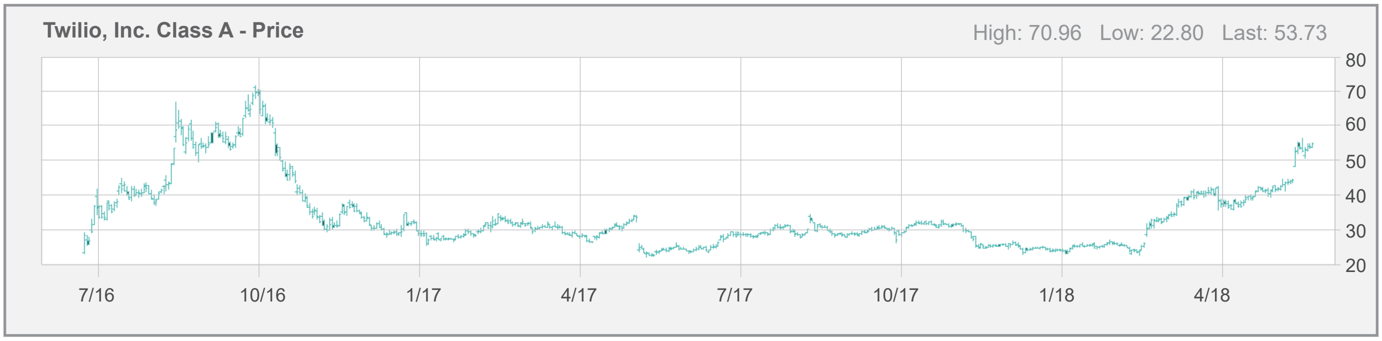
Ultimately, the stock decreased from its high in the upper $60s to a more reasonable valuation in the mid-$20s to low $30's, where it traded until early 2018. Having been favorable on the company's business model at the time of the IPO, the BUFSX team dusted the name off in early 2017 and decided to buy back into the stock.

The BUFSX team likes Twilio because of its transactional revenue model. Every time someone uses their service in an app or uses a website that uses their communications platform, Twilio gets paid, so it's fairly transactional and therefore could be more predictable. Twilio also has a very scalable self-service model. Unlike a lot of SaaS companies, Twilio does not have to hire an army of salespeople to sell their product.





Past performance is not a guarantee of future results.

Source: FactSet

They market their products to software developers who put Twilio's application programming interface (API) into projects the developers are working on. Once they have that developer onboard, the developer continues to put Twilio's APIs into their projects, and Twilio gets paid upon usage.

One of the risk factors the BUFSX team considered when purchasing the stock was customer concentration, namely with Uber, which accounted for 17% of revenue at the time, as well as with WhatsApp, which was a 5% customer but not under contract. There was a little controversy last year as Uber, which was on pace to spend over $50 million with Twilio, decided they wanted to take some of that business in-house and use another provider for some other functions that Twilio had been providing. Revenue from Uber went from almost $15 million a quarter to about $4 million a quarter.

While we were disappointed that Uber lowered their revenues, especially since it caused additional volatility with the stock, the customer concentration risk was subsequently lowered. Uber was still going to be a customer, and outside of Uber, the rest of the company was still growing revenues about 60% year-over-year. We believe there are not many customers that have the software development depth to do what Uber did, and so we remained very comfortable with the position.

The reduction in Uber revenue, as well as some price discounts given to Uber in mid-2017, hurt gross margins, which supports the bear case. However, there were other factors weighing on gross margins, including a higher mix of revenue from Europe, which inherently has lower gross margins. They also experienced a negative impact from foreign exchange, as their network costs are in euros but revenues are in U.S. dollars (USD) and the euro was then rising relative to the USD. Gross margins have since stabilized and have actually started to rise again.

Twilio remains very active with new products and has continued to expand their offering. They partnered with Amazon (NASDAQ: AMZN) on a contact center and a collaboration product that Amazon has launched called Connect. They have recently launched Twilio Flex which is their programmable contact center solution. Most new products have higher gross margins than their current mix of business.

Despite the recent moves in stock price this year (+125% year-to-date as of 5/18/18), Twilio still trades at a fairly attractive valuation relative to the high-growth SaaS peer group that we track, trading at 7.3x 2019 EV/Sales vs peers at 9x. We also believe Wall Street numbers are too low. Furthermore, the comparables get much easier in the second half of the year as the bulk of the Uber revenue declines were in the second half of 2017.

Company	Price	EV	EV / NTM Sales	EV / FY2 Sales
Alteryx	32.42	1,749.87	8.41	7.14
Atlassian	61.64	14,080.50	13.01	12.67
BlackLine	39.52	2,058.19	8.38	7.34
Coupa Software	51.48	2,658.57	10.77	9.27
MongoDB	41.49	1,904.92	8.07	6.61
New Relic	90.13	5,040.87	10.66	8.79
Okta	49.23	5,046.95	13.3	11.03
Paycom Software	101.69	6,076.02	10.21	9.02
ServiceNow	171.71	29,999.72	10.42	8.98
Shopify	146.1	13,939.40	12.03	10.01
Twilio	**53.73**	**4,903.09**	**8.3**	**7.33**
Veeva Systems	76.15	10,304.99	11.96	10.69
Zendesk	55.11	5,623.91	8.89	7.66

Source: FactSet

To remain competitive, Twilio has to continue to provide the best service out there and the broadest geographic coverage, while continuing to write new APIs that are going to get used by their developer customers. Staying out in front and offering a better service than their peers while offering newer products is going to keep them separated from the competition.

Past performance is not a guarantee of future results. *Source: FactSet*

ABOUT THE AUTHOR

Jamie Cuellar, CFA

Jamie joined the Buffalo Funds in 2015 and has 26 years of professional investment experience. At the Buffalo Funds, Jamie works with equity portfolios, and his focus areas include technology and consumer. Jamie received a B.B.A. from the University of San Diego and an M.B.A. in Finance from Southern Methodist University. He also holds the Chartered Financial Analyst designation.

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As of 12/31/17 the Buffalo Small Cap Fund's top ten equity holdings were: Catalent 2.32%, Generac Holdings 2.10%, HealthEquity 2.05%, Zendesk 2.00%, MasTec 2.00%, Monolithic Power Systems 1.98%, Five9 1.94%, Bio-Techne 1.90%, Summit Materials 1.81%, WageWorks 1.80%. Top 10 holdings for the quarter are not disclosed until 60 days after quarter end. Those listed are for the previous quarter.

Definitions: Enterprise Value (EV) is a measure of a company's total value. EV / NTM Sales is a valuation measure that compares the enterprise value of a company to the company's expected next twelve months (NTM) sales. EV / FY2 Sales is a valuation measure that compares the enterprise value of a company to the company's previous two fiscal year sales.

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The Funds' investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory prospectus contains this and other important information about the investment company, and may be obtained by calling (800) 49-BUFFALO or visiting buffalofunds.com. Read carefully before investing.

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