Management CV

Research Note:
Citrix Systems (CTXS)
August 20, 2010

Strong Incentives and Excellent Product Strategy

Citrix Systems CEO Mark Templeton (57) once quoted Abe Lincoln at an industry conference saying "..if I had eight hours to cut down a tree, I would spend the first seven sharpening my axe." In late 2007 CEO Templeton swung his ax and replaced half of his top management team. The changes he made were basically organic—three through internal promotions and only one through an acquisition but the results have been exceptional for CTXS investors. CEO Templeton and his team remain one of our best-in-class management teams for investors looking to leverage the confluence of Cloud computing, open source software, and high speed networks. Our one caution with this management team is their low level of true equity ownership and the high level of option dilution associated with their compensation plans. Recent changes have dramatically reduced CTXS' option overhang and improved management's alignment with outside shareholders and we expect this team's relative outperformance to continue.

Mark Templeton joined Citrix as the VP of Marketing in 1995, about six months before its IPO. He became the President three years later and then, in an unusually mercurial start as the firm's head, he became the CEO a year later (1999) only to be temporarily demoted to the title of senior executive officer after a bad quarter during the Tech crash in 2000, and was then reinstated as the full CEO again in 2001. Since then, Templeton has earned the trust and confidence of his Board and demonstrated a clear strategy for virtualization, and the tactical roll-ups to accomplish that vision, which is arguably the envy of the industry. He has a BA from North Carolina State University, an MBA from UVA's Darden School of Business and also serves on the Board of Equifax, Inc. CFO David Henshall (41) has been with the firm since 2003. Previously he was the CFO at Rational Software (2002-2003) until it was acquired by IBM. He was also the Treasurer at Rational and from 1993 to 1998, he held finance positions with Cypress Semiconductor Corporation. We think that one of the most positive traits in the Citrix corporate culture is that senior executives from acquired companies tend to stay at the firm and continue to make major contributions. Brett Caine (50) joined CTXS in 2004 when it acquired Expertcity.com, where Caine had been the SVP for worldwide sales. From 2004 to 2007, Caine held several roles in CTXS's Online Services Division, and in October 2007, he became the division's SVP. Peter Levine (49) was the CEO of XenSource, that Citrix bought in October 2007. Levine has since served as SVP of Virtualization and Management. He also has an interesting finance background because, prior to leading XenSource, he was a managing director of the Mayfield Fund, a venture capital firm. Alvaro Monserrat (42) is the SVP who runs Sales & Services and has since July 2008. Previously, Monserrat was the VP of Channels and Emerging Products at CTXS for a year, and from 2000 to 2007, he led the Company's divisional sales and consulting efforts. One recent departure, that of APAC region head Dennis Rose in July (to Brightcove), is a notable loss for the team.

We like the relative frugality of the CTXS compensation plan for executives which is set such that the base salaries are just above the 50th percentile of a good industry peer group of 17 technology (mainly software) firms. Management's compensation is weighted toward long term incentives and performance vesting. CEO Templeton receives a salary of $800k and, last year, received a bonus of $954k, options worth $899k and restricted stock worth $2.48 million. His total 2009 compensation package was worth $5.1 million and he received roughly 38% of the senior team's total cash pay and 47% of the total incentive pay. CFO Henshall has a salary of $435k and received a 2009 bonus of $325k with total compensation of $2 million last year. We like the Board's use of concrete financial metrics for bonus targets and the fact that cash bonuses vary widely based on results at CTXS. Management's annual cash bonuses are measured against 85/15 mix of financial and other metrics. The financial component is a simple 50/50 split between a revenue target and an operating margin target, which were $1.6 bil-

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lion and 23.6% respectively last year and which the team exceeded modestly. Last year CEO Templeton received a large amount of restricted stock, but in recent years the Board has generally split management's long-term incentive compensation into three weighted segments of: 50% stock options, 30% in performance-based vesting restricted stock, and 20% in restricted stock that time vests ratably over three years. We like the heavy weighting on the performance vesting components and think that it has played a big part in generating the strong operating results this team has achieved. Under the management's LTIP, they can also earn restricted stock units based on the excess total return of CTXS' stock over a three year period (ending in 2011) versus a weighted average of the S&P 500 (2/3) and S&P North American Tech (1/3) indices. This combination of incentives is an unusually good mix of operating performance and relative return benchmarks that keeps management in tune with outside investors.

While CTXS's overall compensation practices are favorable to shareholders, we note that the senior team's beneficial equity ownership is relatively low. The Board recently revised upward the nominal stock ownership guidelines for executive officers in March this year, though even the new requirements are very modest. Going forward the CEO is required to own a minimum of 100k shares, the CFO 25k shares, and each of the other executives at least 20k shares. CEO Templeton's current beneficial ownership is just over 865k shares so he easily exceeds the requirement, as do CFO Henshall (209k) and SVP Monserrat (65k) but the Directors and Officers as a group only own 1.3% of the roughly 185 million shares outstanding. CEO Templeton has been a modest seller of CTXS shares in the high 30's and low 40's, as has CFO Henshall, in the last six months but XenSource head Peter Levine notably continues to sell large (over $1 million) portions of his shares.

Option dilution is an important consideration for CTXS shareholders. From 2006 to 2008, CTXS granted 18.8 million options, off a starting base of 176.6 million shares. The Company had so many outstanding option grants that the potential option overhang was over 17.2% at the end of 2008. The option overhang was exacerbated by share buybacks of over 82 million shares in the last decade, but the Board has acted decisively to lessen option dilution and has now reduced its aggregate use of options in favor of restricted stock. With the steady rise in the share price since 2009, causing option exercises (CEO Templeton exercised over $4.1 million of his options in 2009), has coincided with lower aggregate grant levels. The Company's option overhang is now much better at approximately 11.6% (we consider an option overhang of 10% or less to be reasonable for a growth company like CTXS). Importantly, the Board has also shortened the term of new option grants to only five years which makes them even more performance oriented incentives for recipients. The weighted average strike price of the outstanding option grants is approximately $33, comfortably in-the-money but still aligned with outside investors.

We like the relatively linear capital allocation strategy of this team and the fact that their gross share repurchases have been relatively constant (at between 7 to 10 million shares) from year to year. CEO Templeton and his team have demonstrated high acquisition integration skill and have generated tremendous free cash flow historically. Cash has been consistently deployed: roughly a third has gone to acquisitions, a third to improve the balance sheet and one-third to buy back shares. Cash & equivalents were over $1.4 billion at the end of the quarter and the Company repurchased about two million shares at an average price of $46.7 during the 2nd quarter and has a remaining authorization of just over $350 million. The firm has recently been aggressively restaffing (after 10% lay-offs in early 2009) in sales, marketing, and R&D in response to strong product demand but we have high confidence in CFO Henshall's ability to sustain recent operating leverage that boosted operating margins by over 1% in 2009. We found no material fiduciary concerns with this management team. All the executives are "at-will" employees and have reasonable change-in-control severance provisions. We continue to think that CTXS represents a very attractive acquisition candidate to strategic buyers like MSFT and ORCL. CEO Templeton's change-in-control benefits are potentially worth in excess of $25 million and CFO Henshall's are worth in excess of $10 million in such an event. We continue to rank both CEO Templeton and his team as #1 top quintile executives. *End*