
CLOUD COMPUTING: WHAT ARE THE BIG PLAYERS TELLING US?

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Each earnings season, we become accustomed to certain patterns. One pattern involves the biggest tech companies reporting earnings before many other smaller and medium sized firms. In what we know is a very difficult economic backdrop, it's important to look for signals that some of the world's largest companies are giving us.

Additionally, since Microsoft Azure, Amazon Web Services, and Google Cloud are three of the world's largest providers of public cloud infrastructure, it's possible that these reports contain details about how companies are spending more broadly on technology. Combining the annual revenues of just these businesses (recognising that they are each part of larger companies) we see spending on cloud infrastructure annually in the hundreds of billions of dollars.

We believe that there is a difference between these three large public-cloud infrastructure providers and the much greater number of far smaller Software-as-a-Service (SaaS) providers. These three firms, for instance, are a major part of most market capitalisation-weighted benchmark indices. They are at a point in their life cycles where they should exhibit sensitivity to broad, global economic activity and growth expectations.

- **What can they tell us?** The most important thing that we think the results of the big public-cloud providers can tell us regards trends in broad-based information technology spending on cloud computing. Eventually, the enterprise market will have 'moved to the cloud' and the growth rates of these large players should drop significantly. We are not yet there so, in this type of environment, we really want to see the resilience of cloud spending in the face of a tougher economic backdrop. There haven't been that many economic slowdowns since the genesis of the cloud business model, and there certainly haven't been sustained periods of inflation or central bank tightening.
- **What don't they tell us?** The smaller SaaS providers tend to help their customers with much more specific business initiatives. It may be accounting, compliance, cybersecurity, data analysis...the list is becoming endless. These companies are more idiosyncratic, in that their individual results do not translate to broad trends as clearly as the biggest company results would. However, we might see strong spending in cybersecurity, for example, and this may not be as clearly visible in the results of the biggest companies.

Our initial sense is that it is important to remember that, in many cases, businesses transitioning to the cloud is done to create efficiency and to accomplish more while investing either less time, less money or less of both. We think that this overall trend

will continue, but it likely won't continue at the rates seen in recent years if the global backdrop is characterised by a deteriorating economic picture. It's also the case that many cloud-focused companies have seen their share prices drop significantly in 2022. This doesn't mean that all the risk is 'priced-in' by any means, but it does tell us that the valuation risk of the space is lower relative to the much higher valuations seen towards the end of 2021.

Microsoft

Microsoft is a leader in the cloud space, and it's important to note that the Azure infrastructure platform is one piece of the overall 'Intelligent Cloud' effort. Most attention goes to the year-over-year revenue growth rates, so it is instructive to first ground any discussion in some of the recent quarterly figures, which are shown in year-over-year terms for Azure specifically below¹:

- 30 September 2021: 50%
- 31 December 2021: 46%
- 31 March 2022: 46%
- 30 June 2022: 40%
- 30 September 2022: 35%

It also helps to look at the overall revenue base to help ground any further thoughts about reasonable growth. While the quarterly results do look at more than the pure Azure revenues, broadening the picture to 'Intelligent Cloud', we see that Microsoft's Intelligent Cloud revenue was \$16.91 billion as of 30 September 2021, and that this figure increased to \$20.33 billion as of 30 September 2022. This is a quarterly figure, and it is beginning to be quite large, so part of the growth rate deceleration that we may be seeing could be attributed to the size and scale of these figures.

Analysts are seeing Azure customers very focused on optimising their cloud workloads, which helps them to save money, and it's also the case that there is evidence that customers are pausing on new workloads. It is reasonable to think that, in an environment of slower economic growth, consumption-based business models like public cloud infrastructure may indicate shifts in customer-behaviour toward more essential workloads².

Amazon

Amazon Web Services (AWS) is the leading public cloud infrastructure platform based on market share, often cited as having a figure around 40% of the total. If we consider the year-over-year growth rates from recent quarters³:

- 30 September 2021: 39%.
- 31 December 2021: 40%
- 31 March 2022: 37%
- 30 June 2022: 33%
- 30 September 2022: 27%

Similar to the case of Microsoft, we are seeing decelerating growth rates. However, if we look to 30 September 2021, the trailing 12-month net sales for AWS was at \$57.2

billion, and this same figure as of 30 September 2022 is \$76.5 billion. These are getting to be quite large numbers.

Also similar to the story with Microsoft, enterprise cloud customers are looking to reduce costs within the AWS ecosystem. Analysts are continuing to note the long-term potential and how this differs from the situation within the shorter-term macroeconomic backdrop⁴.

Alphabet–Google Cloud in focus

Google Cloud, within Alphabet, does trail both Microsoft Azure and AWS in terms of market share, but Alphabet as a whole runs a formidable, cash-rich business, so they have been known to make large, splashy deals to gain high-profile cloud customers. If we note the year-over-year growth figures⁵:

- 30 September 2021: 45%
- 31 December 2021: 45%
- 31 March 2022: 44%
- 30 June 2022: 36%
- 30 September 2022: 38%

The growth rates are similar to what we noted with Microsoft Azure and AWS, but the dollar figures are much lower. As of 30 September 2021, the quarterly revenue from Google Cloud was reported at \$4.99 billion, and then as of 30 September 2022, this figure had grown to \$6.87 billion.

It is notable that, while Microsoft and Amazon saw quarter-to-quarter decelerations in growth rates, Google Cloud is cited as a bright spot of growth acceleration in Alphabet's results. However, we note that Alphabet's core business was certainly not immune to deteriorating economic conditions, and that the revenue figures are growing from a smaller overall base.

Conclusion: the economy matters but this is not the year 2000

The primary conclusion that we reach at this point is that economic conditions do matter for cloud computing companies. We have already seen their share price performance for 2022; it is crystal clear that market participants have re-assessed the appropriate valuation multiples for these firms considering higher inflation and higher interest rates. We will be watching closely to see how much revenue growth these companies can maintain as they continue to report earnings for the period ended 30 September 2022. The biggest companies, so far, have reported a range of 27% to 38%. It clearly isn't the euphoric environment of 2020 any longer, but we don't think it appropriate to say a 'tech bubble is bursting' either.

Sources

¹ Source: Microsoft's First Quarter Fiscal Year 2023 Results, 25 October 2022. Revenue figures presented in the generally accepted accounting principles (GAAP) format.

² Source: Sills, Brad & Adam Bergere. "Expected Azure decel likely temporary, cyclical; model largely derisked." Bank of America Securities. 26 October 2022.

³ Sources: Amazon's Quarterly Earnings Conference Call Slides for the specific periods ended: 30 September 2022, 30 June 2022, 31 March 2022, 31 December 2021 and 30 September 2021. The revenue growth figure is taken as the year-over-year growth without foreign exchange adjustment.

⁴ Source: Post, Justin & Michael McGovern. "Expecting Less this Holiday." Bank of America Securities. 28 October 2022.

⁵ Sources: Alphabet's Quarterly Earnings Announcements which specify the revenues from different business units on a quarterly basis for the periods ended: 30 September 2022, 30 June 2022, 31 March 2022, 31 December 2021 and 30 September 2021. Percentage growth is calculated directly from the figures that Alphabet reports for Google Cloud, all in USD terms.

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