
CLOUD COMPUTING: KEEP LOOKING AT THE GROWTH!

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As we write these words, we are roughly halfway through the month of November 2022. Investors globally remain focused on inflation, the policy path of the US Federal Reserve (Fed), as well as the earnings reports of individual companies highlighting their results for the quarterly period ended 30 September 2022.

Amongst the many software-as-a-service (SaaS) companies delivering their products through the cloud computing business model, a few narratives are emerging:

- Many, though not all, companies are reporting positive results that beat consensus expectations for the period from 30 June 2022 to 30 September 2022.
- Almost all companies are then guiding expectations downwards for the period from 30 September 2022 to 31 December 2022.
- Share price performance—depending, of course, on the macroeconomic announcements happening concurrently—has tended in the downward direction, following the narrative that growth in the current period is slowing and the cloud business model is therefore not immune to a possible recession or generally more difficult economic conditions.

A tale of two companies: Twilio versus Toast

We can look at summary results of two companies, very recently reported, that showcase the more general trends.

*Twilio: A Great Quarter, but Hammered on the Forward Guidance*¹

For the period ended 30 September 2022, Twilio generate revenue of \$983 million, over consensus estimates of \$972 million and representing growth of 33% year-over-year. This was the ‘good result’.

Twilio then noted that fourth-quarter 2022 revenue could be in a range between \$955 million to \$1.005 billion, which would correspond to year-over-year growth of 18-19%. However, this would be below the consensus estimate of \$1.07 billion. This would be the ‘lower guidance’.

Then, there was this quote from Chief Operating Officer, Khozema Shipchandler, noted in a letter to shareholders:

Like many of our software peers, we’re seeing negative impacts on our business from the macro environment. As a result of the worsening macro situation, we also feel it is

prudent to pull the 30%+ revenue growth target today. We still believe we'll deliver attractive levels of growth going forward, but in the current market, we don't believe 30%+ is achievable.

The day after these results and guidance were made, the share price dropped about 35%. We'd note that Twilio, as a business, is delivering on the same services and mission it was before, but has noted that revenue growth expectations have to be more reasonable. While it shouldn't be as surprising as it was, given the news we see every day, it's exactly the narrative that investors do not want to hear, hence the short-term punishment.

Toast: Raising Forward Guidance Amidst an Uncertain Macro Environment²

There are some companies that are actually increasing their forward guidance after reporting strong results. Toast fits into this category.

For the full-year, Toast raised its expected revenues to a range between \$2.692 billion to \$2.722 billion, from a prior guidance range of \$2.2 billion to \$2.66 billion. For the quarter set to end 31 December 2022, Toast raised the guidance range of \$730 million to \$760 million, when the consensus expectations were merely \$725 million.

For the period ended 30 September 2022, Toast grew revenues year-over-year by 55%, reaching \$752 million. Gross payment volume—noting that this is a key part of Toast's restaurant management software—was \$25.2 billion, meaning that the company is now on an annual pace to exceed \$100 billion in gross payment volume for the first time.

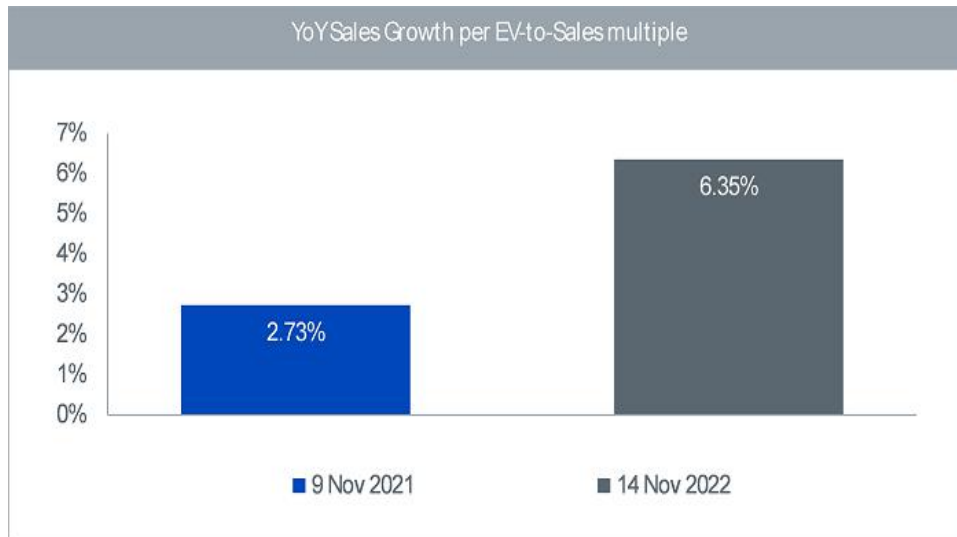
So, it's important to note that not all cloud computing companies are lowering guidance for the current period.

The bottom line: growth vs valuation

One year ago, in November 2021, nearly all of our discussions around cloud computing were about the high valuation. We would encourage all investors looking at cloud computing to always try to think of both valuation and growth together. Figure 1 shows a measure of year-over-year sales growth per unit of enterprise value (EV)-to-Sales multiple, meaning:

- 9 November 2021: The EV-to-Sales multiple of the BVP Nasdaq Emerging Cloud Index was 15.17x, whereas the weighted average sales growth was 41.40%. If we divide $41.4/15.17=2.73$. Growth was high, but the investor was paying up for it.
- 14 November 2022: The EV-to-Sales multiple of the BVP Nasdaq Emerging Cloud Index was 4.70x, whereas the weighted average sales growth was 29.86%. If we divide $29.86/4.70=6.35$. The multiple has dropped a lot, and while the growth has decelerated, the valuation decelerated at a faster rate. The investor is now getting more units of growth for less money than they paid for those units of growth roughly one year ago.

Figure 1: Year-over-year sales growth per Enterprise Value-to-Sales (EV-to-Sales) multiple



Source: WisdomTree, Bloomberg.

All fundamentals data is from Bloomberg. EMCLLOUDN is the BVP Nasdaq Emerging Cloud Index. In the calculation of presented metrics the underlying index constituents and weights are fixed as of 14 November 2022 and only fundamentals data is changing. Sales growth is represented by a weighted average sales growth of the index constituents. Sales growth for the underlying constituents is computed year-over-year from either quarterly, semi-annual or annual data, based on whichever is available in Bloomberg starting from quarterly data. EV-to-Sales is represented by a weighted harmonic mean of the EV-to-Sales for the index constituents. EV-to-Sales for the underlying constituents is represented by a ratio of Enterprise Value (EV) over trailing twelve-month Sales.

You cannot invest directly in an index.

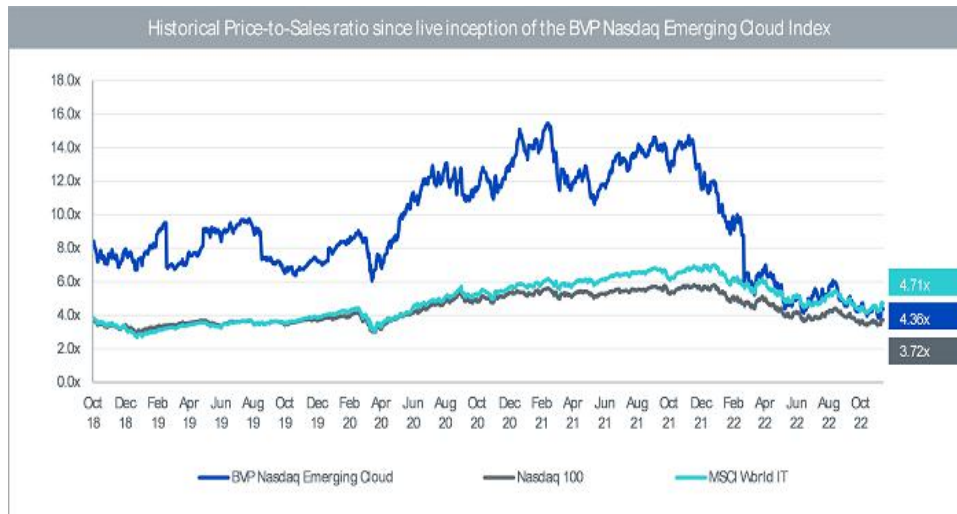
Historical performance is not an indication of future performance and any investments may go down in value.

The path = our emotional memory

Investors don't 'feel great' when we speak to them, generally, about their tech investments, their growth investments or their software investment in 2022. This is not because the world isn't using tech or software, but rather it is because these stocks have rapidly adjusted—through massive multiple contraction—to the shift we are all watching from 0% interest rate policies to much higher interest rate policies.

But, as we see in Figure 2, if we can reset our thinking, starting from the present period, we can see that the BVP Nasdaq Emerging Cloud Index is trading at a valuation that is quite similar to the more general, broad tech benchmarks, such as the Nasdaq 100 Index or the MSCI World Information Technology Index. If these cloud companies can hold on to faster growth than the broad tech markets, this creates an interesting opportunity for investors with longer time horizons.

Figure 2: Historical Price-to-Sales ratio since live inception of the BVP Nasdaq Emerging Cloud Index (2 October 2018 to 14 November 2022)



Source: WisdomTree, Bloomberg.

Period from 02 October 2018 to 14 November 2022. Historical Price-to-Sales ratio data is from Bloomberg.

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Conclusion: it’s all about the growth

Cloud companies need to weather the macroeconomic storm of the present period, and those that are able to hang on to their ability to showcase growth will be well positioned for what many are calling the coming ‘pivot.’ We don’t know exactly when the US Federal Reserve will stop raising interest rates, but we are seeing (just look at the performance observed on 10 and 11 November 2022) that the market is keyed into anything that even appears helpful in the case for less tightening. We believe that the long-term picture will be determined by the capability of companies in the BVP Nasdaq Emerging Cloud Index to continue to grow, even if the short-term picture may be more determined by movements in interest rates and interest rate expectations.

Sources

¹ Source: Savitz, Eric J. “There’s New Trouble Brewing in Cloud Stocks. Twilio and Atlassian Issue Growth Warnings.” Barron’s. 4 November 2022.

² Source: Dattilo, Emily. “‘Toast Is On Fire’ as Management Lifts Outlook. The Stock Is Higher.” Barron’s. 11 November 2022.

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