
CLOUD COMPUTING: BEYOND THE FOG OF MACRO THERE IS A FUNDAMENTAL FOUNDATION

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So far, 2022 has been a year of the [value](#) style of investing outperforming the [growth](#) style, and few megatrends in recent years have been more growth-oriented than [cloud computing](#). Big stories and sales growth went from being in favor during 2020 and 2021 to completely out of favor in an environment of higher inflation and [interest rates](#).

However, do we risk painting an entire megatrend with too broad a brush? If most cloud computing companies are trading based more on macroeconomic factors, opportunities can be created because the companies where positive things are happening are being pulled down along with everything else.

Anyone interested in cloud computing and [Software-as-a-Service \(SaaS\)](#) businesses would do well to follow Jason Lemkin's [SaaSr](#) blog. Some of the examples I point out in the text that follows were inspired by his writing, and it is excellent food for thought in finding positive financial developments in these companies.

Zoom Video Communications

It's possible that the biggest value of Zoom is it is a global brand everyone knows. There is even such a thing as "Zoom fatigue"—meaning that the product is used so much there is common language to describe using it too much.

But is this just a "pandemic darling," or is this a business with a significant future outside the COVID-19 pandemic?

Customer Cohorts Are Changing

Customers that generate more than \$100,000 in recurring revenue are the engine for future growth. This group of customers, roughly 2,900 in number, is growing 46% year-over-year. This could be Zoom's ultimate future, but it will be a journey. Even in 2021, 63% of Zoom's revenue was still from 10-seat or smaller customers.¹

Cost Control

I was fascinated and even surprised to see that Zoom's sales and marketing spending is around 25% of revenue, having grown a bit from a level of 20%. The reason for the spending expansion is to facilitate Zoom's transition toward enterprise customers. The typical Software-as-a-Service company is spending something closer to 50% of revenue on sales and marketing, so Zoom is operating at roughly half the scale of the typical SaaS business, at least on the basis of measuring its expenditure this way. This is a big reason why Zoom is able to generate roughly \$2 billion of adjusted free cash flow per year. In the current environment, if these stocks start trading less on macroeconomic factors and more on fundamentals, we believe that the capability to transition from revenues to free cash flows to earnings will be prized, and Zoom is doing this².

Multi-product Expansion

Zoom has annual recurring revenue of about \$4 billion, and the vast majority of this comes from its core video communications product. However, Zoom's phone product does have about three million users. We can recognize that Zoom attempted to acquire Five9,

which didn't work out, but it is still seeing growth in its phone product. It will just take time for the phone product to get big enough to materially impact the \$4 billion in annual recurring revenue.

Sprout Social

Sprout Social is a company that helps increase the impact of brands, people and companies on social media.

Growth Acceleration

Consider these growth rates at different levels of annual recurring revenue:³

- \$100 million: 30% growth.
- \$180 million: 34% growth.
- \$240 million: 41% growth.

We recognize that this past behavior doesn't guarantee any future growth rates, but it's at least worth continuing to watch Sprout's results. If it can maintain this trajectory for a time, when cloud computing stocks trade more on fundamentals and less on macroeconomic factors, its performance could be quite interesting.

Cost Control

As mentioned with Zoom, the typical SaaS company spends around 50% of annual recurring revenue on sales and marketing expenses. Sprout is spending about 39%, which is below the key measure of 40% that has tended to be associated with better performance on free cash flows. Sprout Social is generating 9% free cash flow at \$240 million in annual recurring revenue, a level that many SaaS companies don't see until \$500 million or even \$1 billion in annual recurring revenue, speaking to a certain degree of efficiency in the business.⁴

Box

Box provides a solution that allows for efficient file sharing and data storage.

Operating Margins

Again, we note that the market today cares far less about the "story" and more about the discipline and execution. I'll admit that I had to read the following a few times to make sure that I had it right and that I wasn't making a mistake:⁵

- Box had a 1% operating margin in 2020.
- Box most recently reported an operating margin of 20%.

That is an incredible display of discipline, helped by the fact that sales and marketing expenses have been driven down to a low of 28% of annual recurring revenue. Box is approaching a free cash flow level that is almost 20% of revenue, which is a significant figure for a SaaS company.

Conclusion: Remember the Digital Transformation

Cloud computing is certainly a high-[volatility](#), high-[risk](#) megatrend, and we recognize that the first half of 2022 has been tough on the basis of share price performance. However, we were recently asked how these companies might fare in an environment of rising rates and higher inflation. While there is no guarantee that customers won't cancel subscriptions—and many cloud companies operate on subscription models—we tend to think about why customers are subscribing in the first place.

Even before the COVID-19 pandemic, there was a push toward digital transformation. Companies were largely doing this to increase efficiencies, make better use of data and run their businesses in a more optimal way. The present environment makes us think that there could be an even greater value on businesses saving costs and finding efficiencies. To the extent that cloud subscription services can actually help businesses continue operating and save costs, we think this is a very interesting space for consideration.

For those interested in the cloud computing space, consider the [WisdomTree Cloud Computi](#)

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As of June 28, 2022, WCLD held 1.69%, 2.13% and 1.81% of its weight in Zoom Video Communications, Sprout Social and Box, respectively.

¹ Source: Jason Lemkin, “5 Interesting Learnings from Zoom at \$4.3B in ARR,” SaaStr, 6/8/22.

² Source: Lemkin, 6/8/22.

³ Source: Jason Lemkin, “5 Interesting Learnings from Sprout Social at \$240,000,000 in ARR,” SaaStr, 6/15/22.

⁴ Source: Lemkin, 6/15/22.

⁵ Source: Jason Lemkin, “5 Interesting Learnings from Box at \$1 Billion in ARR,” SaaStr, 6/1/22.

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DEFINITIONS

Value: Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Growth: Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Cloud computing: computing capabilities deployed via internet connection in form of applications, platform services, or infrastructure.

Interest rates: The rate at which interest is paid by a borrower for the use of money.

Software-as-a-Service (SaaS): Software applications provided over a network connection.

SaaStr: The world's largest community of SaaS executives, founders, and entrepreneurs.

Volatility: A measure of the dispersion of actual returns around a particular average level.

Risk: Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.