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

Christopher Gannatti — Global Head of Research
07/05/2022

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 *SaaStr* 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 this[2].

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 Computing Fund.

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.

Important Risks Related to this Article

Christopher Gannatti is an employee of WisdomTree UK Limited, a European subsidiary of WisdomTree Asset Management Inc.'s parent company, WisdomTree Investments, Inc.

There are risks associated with investing, including the possible loss of principal. The Fund invests in cloud computing companies, which are heavily dependent on the internet and utilizing a distributed network of servers over the internet. Cloud computing companies may have limited product lines, markets, financial resources or personnel and are subject to the risks of changes in business cycles, world economic growth, technological progress and government regulation. These companies typically face intense competition and potentially rapid product obsolescence. Additionally, many cloud computing companies store sensitive consumer information and could be the target of cybersecurity attacks and other types of theft, which could have a negative impact on these companies and the Fund. Securities of cloud computing companies tend to be more volatile than securities of companies that rely less heavily on technology and, specifically, on the internet. Cloud computing companies can typically engage in significant amounts of spending on research and development, and rapid changes to the field could have a material adverse effect on a company's operating results. The composition of the Index is heavily dependent on quantitative and qualitative information and data from one or more third parties, and the Index may not perform as intended. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For the top 10 holdings of WCLD please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/megatrends/wcld

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

Related Funds

+ WisdomTree Cloud Computing Fund

+ WisdomTree Cybersecurity Fund

+ WisdomTree Artificial Intelligence and Innovation Fund

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

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 tim.

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 connectio.

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.