Cloud computing: Beyond the fog of macro there is a fundamental foundation

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2022, so far, 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 favour during 2020 and 2021 to being completely out of favour 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 more based on macroeconomic factors, opportunities can be created because the companies where positive things are happening are being pulled downwards 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 that I point out in the text that follows were inspired by his writing, and it's 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 the fact that they are a global brand that everyone knows. There is even such a thing as 'Zoom fatigue'—meaning the product is used so much that there is common language to describe using it too much.

But, is this just a 'pandemic darling' or is this a business that has a significant future outside of the Covid-19 Pandemic?

Customer Cohorts are Changing

Customers that generate more than $100,000 plus in recurring revenue are the engine for future growth. This group of customers, roughly 2,900 in number, are 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 customers1.

Cost Control

I was fascinated and even surprised to see that Zoom's sales and marketing spending is around 25% of revenue, having grown from 20%. The reason for the expansion of spending is to facilitate Zoom's transition more towards 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 their 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 revenues of about $4 billion, and the vast majority of this comes from the core product of video communications. However, Zoom's phone product does have about 3 million users. We can recognise that Zoom attempted to acquire Five9, which didn't work out, but they are still seeing growth of their phone product. It will just take time for the phone product to get big enough to materially impact the $4 billion in annual recurring revenues.

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 revenue3:

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

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

Cost Control

As mentioned with Zoom, the typical SaaS company spends something around 50% of annual recurring revenue on sales and market expenses. Sprout is spending about 39%, which is below a key measure of 40%, which 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, which is a level that many SaaS don't see until $500 million or even $1 billion in annual recurring revenue, speaking to a certain degree of efficiency in the business4.

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 the execution. I'll admit that I had to read the following a few times to make sure that I had it right and I wasn't making a mistake5:

- 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 has been driven down to a low of 28% of annual recurring revenues. Box is approaching a level of free cash flow 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 recognise that the first half of 2022 has been tough on the basis of share price performance. However, we were recently asked about how these companies might fare in an environment of rising rates and higher inflation. While there is no guarantee that customers don'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.

1 Source: Lemkin, Jason. "5 Interesting Learnings from Zoom at $4.3B in ARR." SaaStr. 8 June 2022.

2 Source: Lemkin, 8 June 2022.

3 Source: Lemkin, Jason. "5 Interesting Learnings from Sprout Social at $240,000,000 in ARR." SaaStr. 15 June 2022.

4 Source: Lemkin, 15 June 2022.

5 Source: Lemkin, Jason. "5 Interesting Learnings from Box at $1 Billion in ARR." SaaStr. 1 June 2022.

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