

Is Investing in Cloud Companies Dead in 2022?

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Thus far in 2022 the volume with which 'rising interest rates' has been trumpeted has been deafening. Whether people are looking at inflation or upcoming Federal Reserve (Fed) policy, it's been impossible to ignore.

The initial casualty? Tech companies in the earlier stages of their life cycles with either very low or even negative earnings.

- In a zero interest rate world, many of these companies were supplying important 'work-from-home' services and software, and the future-oriented cash flows could be valued more highly, pushing up valuations.
- With higher rates, it's not that these companies immediately cease to exist, but the market has to re-evaluate the appropriate multiples of forward-looking revenues and earnings, in many cases functioning like the force of gravity on elevated share prices from the past few years.

Therefore, does it make sense to ignore cloud computing in 2022—a megatrend that boasts many of these software companies with low or negative current earnings?

Megatrends and Time Horizons

Think about this question:

If you were reading about a megatrend that was expected to last only one year, how would you react?

I have done many 'megatrend' presentations, and my feeling from this experience is that one of the first things investors want to see with a megatrend is an extended time horizon. If an audience feels that a trend won't have legs beyond three or even five years, it is tough to convince them that your topic even qualifies.

Therefore, one of the first things to do is reframe our baseline.

- If the top priority is 2022 performance, full stop, then cloud computing as an investment strategy could be challenging. What we know today would make this a difficult choice.
- If we are thinking of investment horizons ten years (or more) out, the interest rate transition could create some interesting opportunities, making good businesses less expensive on a share price basis. Interest rates won't go up continuously for a decade, so a longer horizon could make 2022 potentially interesting for points of entry, relative to late 2020 or different parts of 2021.

What is Happening with the Cloud?

Cloud computing is really just infrastructure—it is a way to access software or computing power that is more effective and efficient than directly owning every piece of software and every piece of hardware that you would ever need, physically on-premise.

Boom Supersonic, a start-up that has already promised to deliver 15 supersonic jets to United Airlines is an interesting example.

History has shown that supersonic passenger transport is not easy. The prior example, the Concorde, took 25 years in development and \$5 billion to launch its first commercial flight, an event that occurred in 1976. Boom believes it can cut down this development time by 50%, and to do so at a much more efficient cost. How was this done? The primary method was access to cloud supercomputing. Simulations allowed Boom to replace most of the physical prototyping and wind tunnel testing required by the Concorde¹. To put numbers to it²:

- Boom could afford to quickly run 53 million compute hours, using Amazon Web Services infrastructure.
- If the need arose to shift to 100 million compute hours—this would be easily doable in short order.

This is merely one example how broader access to supercomputing infrastructure could help one specific company develop one specific thing. It's true that many other megatrends, like artificial intelligence or biotechnology, will be taking full advantage of this. Importantly, these are multiyear projects with few expected to completely finish in 2022. Many are just starting.

The Big Players have Continued to Grow at 30% or More

If the largest companies in a particular space are continuing to exhibit strong growth, we believe it says something about the opportunity set within the broader space. Amazon and Microsoft are by far the largest players in the public cloud:

- Amazon has noted the size of its cloud business, by revenue, at \$16.1 billion in its most recent quarter, indicating 39% year-over-year growth³.
- Microsoft has noted the size of its cloud business, by revenue, at \$20.7 billion in its most recent quarter, with growth at 36% year-over-year⁴.

Now, it would be incorrect to assume that all cloud-oriented players are the same—it's certainly not a monolithic megatrend. Many have looked at Zoom Video Communications, which was the quintessential work-from-home service and that has been transitioning from reporting revenue growth of roughly 350% year-over-year during its quarterly earnings calls in 2020 to something more reasonable, maybe 30-40% more recently⁵. There are companies like that, where the pace of 2020 growth was not going to be sustainable and where companies will still grow but will have to adjust to more normal conditions.

Established Companies can use their Cash Hoards to Make Deals and Continue their Growth

Alphabet's Google Cloud is not yet a leader in cloud computing, at least not yet on par with Amazon or Microsoft. In its most recent quarter, Google Cloud grew at 45% year-over-year in terms of revenue, but this got it to a level of \$4.99 billion⁶. However, Alphabet overall has a very large cash store--\$142 billion. During 2021, deals were announced where Google took a stake in Chicago Mercantile Exchange (CME) Group and Univision, and then these companies made commitments to use Google Cloud, in some cases in arrangement that could be worth more than \$1 billion in revenue to Google⁷.

Google has a roughly 6% market share in the public cloud, as compared to Amazon at 41% and Microsoft at 20%⁸. It cannot be underestimated what all three of these companies can do with their cash levels to incentivise customers and acquire new capabilities.

Conclusion: Those Looking Further than 2022 Could see Opportunity in Cloud Computing

In the end, even if the initial landscape brings the challenges into sharp relief more than the opportunities, we would encourage investors not to completely forget cloud computing. It is clear that many of these companies will see their valuations adjust to a non-zero interest rate environment, but their business models and services that they provide remain important and in strong demand. With an appropriately long time horizon, there could be opportunity in software oriented companies like this in 2022.

1 Source: Poort, Joris. "How Cloud-Based Supercomputing is Changing R&D." Harvard Business Review. 29 November 2021.

2 Source for Bullets: Poort, 2021.

3 Source: Herrera, Sebastian. "Amazon Earnings Suffer as Growth Slows, Costs Rise." Wall Street Journal. 28 October 2021.

4 Source: Tilley, Aaron. "Microsoft Earnings Jump as Cloud Services Thrive." Wall Street Journal. 26 October 2021.

5 Source: Gallagher, Dan. "Zoom has Some Unhappy Hours Remaining." Wall Street Journal. 23 November 2021.

6 Source: Mickle, Tripp. "Google Nearly Doubles Profit Behind Red-Hot Ad Market." Wall Street Journal. 26 October 2021.

7 Source: Mickle, Tripp & Aaron Tilley. "Google and Tech Rivals Tap Cash Reserves to Realise Cloud Ambitions." Wall Street Journal. 29 December 2021.

8 Source: Mickle & Tilley, 2021.

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