Software sector in transition: Q3 growth trends and AI integration

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Key Takeaways

- Sales growth for EMCLOUD holdings has declined since 2022 but remains higher than the broader Nasdaq-100, showing relative strength in the software sector.
- Software companies with stronger AI integration reported significantly higher sales growth, suggesting AI investments could fuel the next growth cycle.
- Q3 2024 saw 97% of EMCLOUD holdings exceed sales expectations, reflecting a strong sales surprise.
- Declining free cash flow margins in recent quarters may indicate increased spending on growth initiatives.

Software companies used to be pursued by investors due to their high growth rates and gross margins. However, after experiencing a surge in sales growth during the period of zero interest rate policies, the sector has faced challenges, including declining growth and the headwinds of elevated interest rates. However, with Q3 2024 earnings released, certain indicators are suggesting a potential shift. *Note, in this article, we will be using the BVP Nasdaq Emerging Cloud Index (EMCLOUD) to represent the software industry.*

Performance review

Software share prices have experienced a rollercoaster 15 months. The EMCLOUD Index rallied by 28% in the last two months of 2023, spurred by a sharp decline in the US 10-year government bond yield (which fell over 100bps during the same period). However, in Q2 and Q3 2024, the sector faced dual pressures: macroeconomic headwinds from higher interest rates and fundamental challenges due to slowing sales growth.

In Q4 2024, the sector rebounded, driven by market optimism following the US presidential election. Trump's win boosted confidence, as his proposed policies included potential corporate tax cuts and reduced regulatory constraints. The EMCLOUD Index surged by about 16% in the month following the election. However, this optimism was dampened by hawkish statements from the Federal Reserve (Fed), accompanied by a 40bps increase in the US 10-year government bond yield from early December's low. Powell's speech suggested less rate cuts in 2025, creating some uncertainty from a macro perspective.

Figure 1: EMCLOUD Index cumulative performance and US 10-year govt. bond yield from 01 September 2023 to 31 December 2024



Source: WisdomTree, Bloomberg, as of 31 December 2024. **You cannot invest directly in an index. Historical performance is not an indication of future results and any investments may go down in value.**

Sales growth and FCF margin

By 31 December 2024, all EMCLOUD Index holdings had released their Q3 earnings. These results provided a clearer picture of the sector's performance.

Sales growth for EMCLOUD holdings has been on a downward trend since Q1 2022. This decline started after the Fed began raising interest rates. Median sales growth rates of holdings from EMCLOUD and the Nasdaq-100 index have followed a similar downward trend, though the decline slowed in the most recent quarter. Despite the slowdown, EMCLOUD continued to provide higher sales growth than the Nasdaq-100 in Q3 2024, with a median of 14.8% compared to 7.0%.

The median free cash flow (FCF) margin for EMCLOUD holdings rose from nearly zero in early 2022 to over 20% in Q1 2024. This increase occurred as sales growth slowed, reflecting improved operational efficiency. However, the FCF margin in the most recent two quarters has shown a lower level compared to Q1 2024. These figures provide useful insights into short-term trends, though they may be influenced by seasonality. Further quarterly data will be needed to determine if this reflects a sustained shift. Rising expenses in recent quarters could signal renewed investments aimed at driving future growth. As we enter

significant technological shifts, driven by artificial intelligence (AI), software companies are increasingly allocating resource to AI, which may lead to another growth cycle.

Figure 2a: Sales growth medians of holdings in EMCLOUD index and Nasdaq-100 index

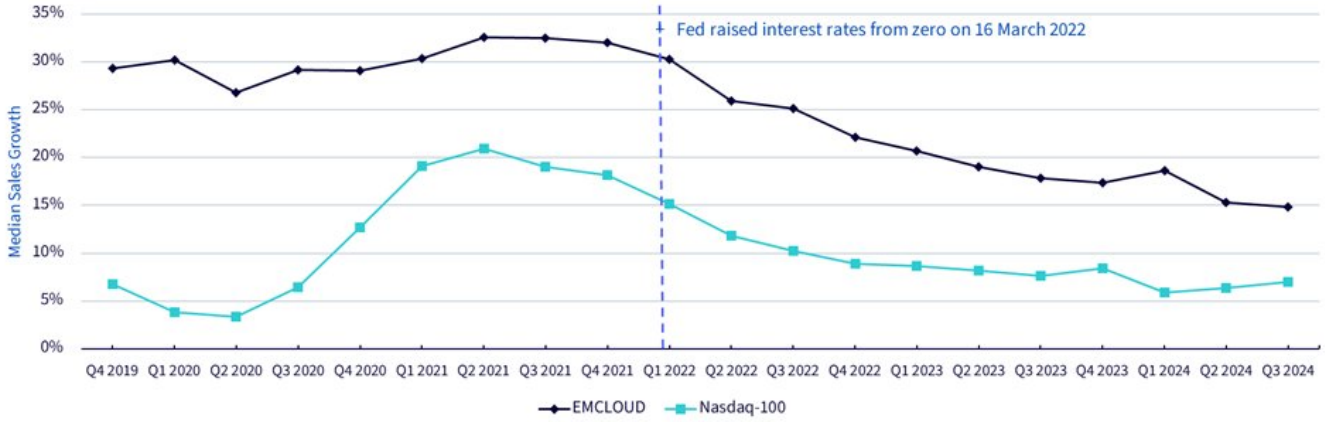
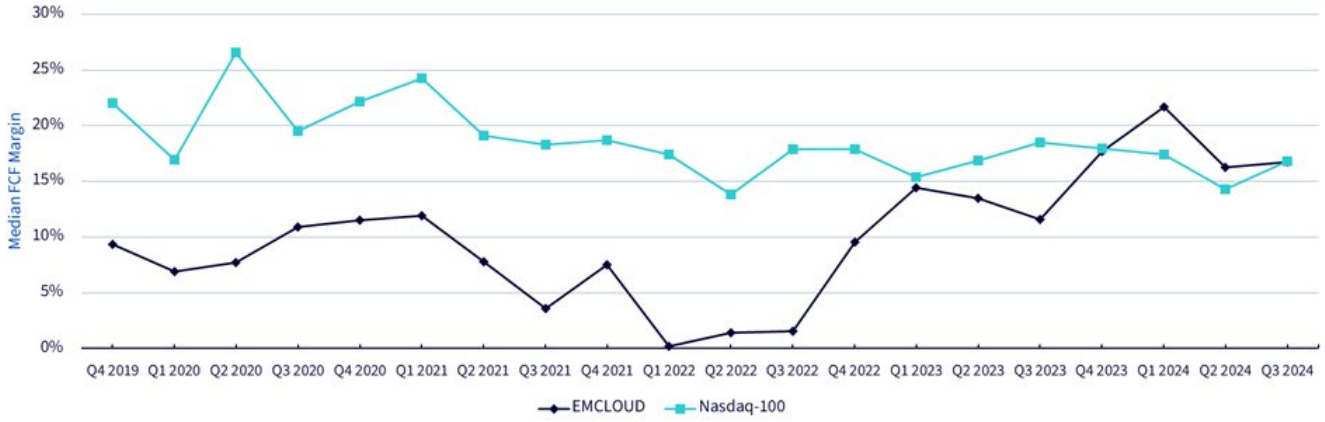


Figure 2b: FCF margin medians of holdings in EMCLOUD index and Nasdaq-100 index



Source: WisdomTree, Bloomberg, as of 31 December 2024. Sales growth rates are based on year-over-year changes in quarterly revenue. FCF margins are based on the quarterly revenue and free cash flows. The Q3 2024 data denotes the financials for the fiscal periods that ended in September or October 2024. **You cannot invest directly in an index. Historical performance is not an indication of future results and any investments may go down in value.**

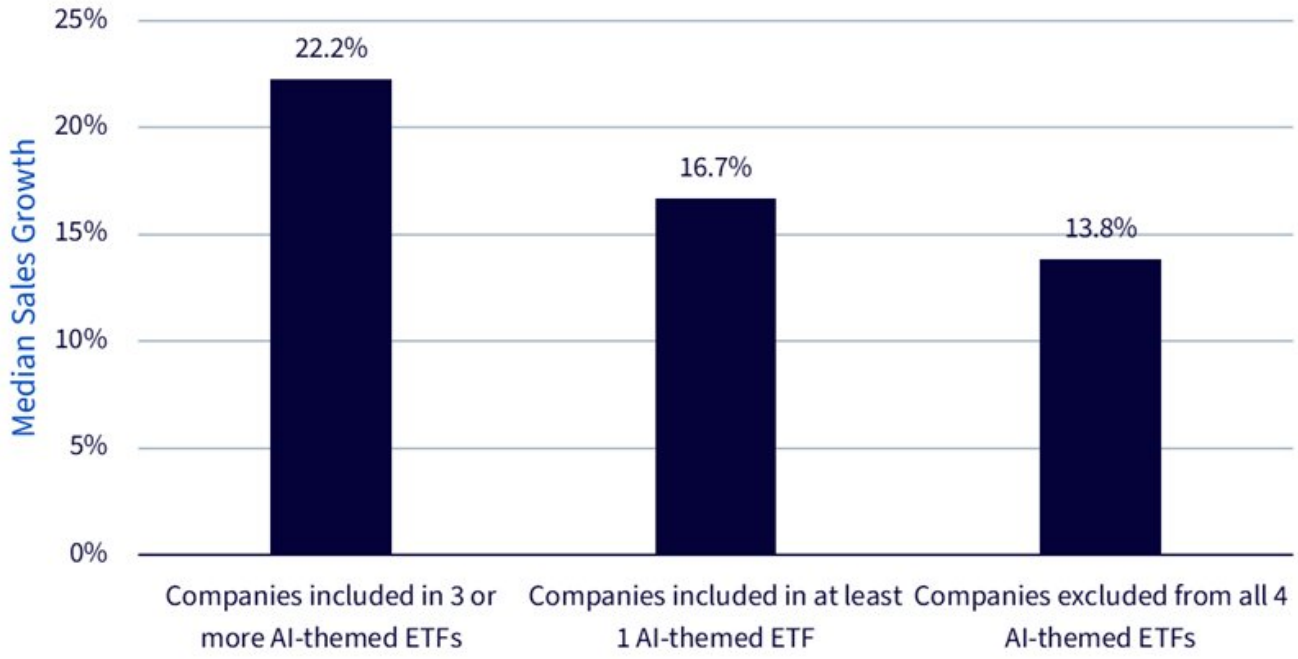
Will AI lead a new cycle of growth?

Will investing in AI lead to higher growth? In the long term, the answer is yes. The Q3 data suggests that the shift toward AI is already making an impact.

As the degree of integration with AI can vary across different software companies, we grouped the holdings in the EMCLOUD Index based on whether the companies are included in the four largest AI-themed exchange-traded funds (ETFs) in Europe by AUM. Figure 3b shows that the group of companies that are included in at least three of the AI funds has the highest median sales growth in Q3 2024 (22.2%). On the contrary, the group of companies that is not included in any of the 4 AI funds has the lowest median sales growth at only 13.8% in Q3 2024. While one quarter of data is not enough to confirm a trend, the large divergence between the highest AI integrated group and the lowest AI integrated group suggests that integration with AI could be the main driver of the next growth cycle for software companies.

Figure 3a: How are EMCLOUD's holdings overlapping with the 4 largest AI thematic ETFs in Europe

Figure 3b: Sales growth comparison among EMCLOUD holdings based on AI integration levels

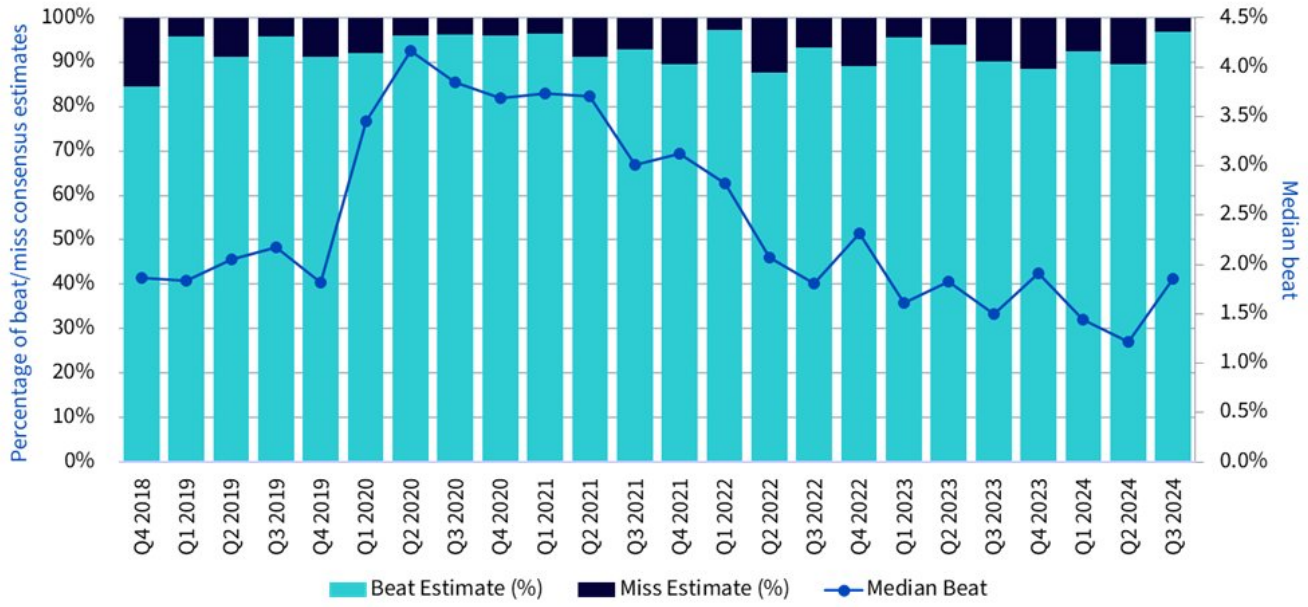


Source: WisdomTree, Bloomberg, as of 23 December 2024. Sales growth rates are based on year-over-year changes in quarterly revenue for Q3 2024. The Q3 2024 data denotes the financials for the fiscal periods that ended in September or October 2024. **You cannot invest directly in an index. Historical performance is not an indication of future results and any investments may go down in value.**

In addition, if we zoom into market sentiment, Q3 sales did perform generally well compared to consensus estimates—around 97% of EMCLOUD holdings reported higher sales than the consensus estimates, which was the highest level since Q1 2022, and the 'median sales beat' for Q3 2024 was 1.9%, higher

than the first two quarters in 2024. Such metrics might indicate a turning point for market sentiment, but whether this upside trend continues in the next year will need to be monitored.

Figure 4: How are EMCLOUD holdings doing relative to consensus estimates (Q4 2018 to Q3 2024)



Source: WisdomTree, Bloomberg, as of 31 December 2024. The median beat denotes the median of volume by which reported sales exceed consensus estimates in percentage. Consensus estimates denote the means of analysts' estimated sales available on Bloomberg. The Q3 2024 data denotes the financials for the fiscal periods that ended in September or October 2024. **You cannot invest directly in an index. Historical performance is not an indication of future results and any investments may go down in value.**

Conclusion

From 2020 until now, growth and interest rates have played key roles in software companies' share prices. Though growth was under pressure when interest rates were high, the Q3 2024's FCF margin shows a potential rotation from efficiency-oriented to growth-oriented. Software companies with strong AI integration are already showing higher sales growth, which suggests that AI could be a key driver leading the next cycle of growth.

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