

What we learned from the 2023 State of the Cloud Report from Bessemer Venture Partners

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Each year, Bessemer Venture Partners (BVP) publishes their 'State of the Cloud' report. Anyone interested in understanding how software-as-a-service (SaaS) companies are doing within the current market environment would benefit from reading this report, accessible [here](#).

BVP is WisdomTree's expert partner behind the BVP Nasdaq Emerging Cloud Index, frequently referenced as 'EMCLOUD'. This is a useful index that investors look at when they want to isolate the performance of SaaS companies over a period of time.

The following two areas in the BVP 2023 State of the Cloud Report caught our attention:

1) **'Profitability vs Growth' tug-of-war.** People like simple answers. But for a SaaS business, when choosing profitability or growth, it is best to think of it like a slide rule along a spectrum—the middle signaling both are equally important, while across time you would see the slider moving to one side or the other depending on the market's current preference. BVP's analysis helps visualise how this slide rule has been moving around.

2) **Artificial intelligence (AI).** Particularly in the context of the large language models (LLMs) that characterise state-of-the-art in generative AI. BVP makes a very clear connection between how many SaaS businesses will need to incorporate generative AI functionality if they want to be successful in the coming decade. If generative AI truly takes off, BVP makes a compelling case that SaaS companies should be among the best beneficiaries.

To focus on growth or profitability? Understanding the SaaS slide rule.

For the majority of time after the Global Financial Crisis of 2008-09 and up until March 2022, the US Federal Reserve (Fed) set its Federal Funds Policy Rate very close to zero, creating an historically low cost of capital for all companies in the US. It was easy for founders to access greater sources of funding, and that funding was more easily seduced by great stories of large total addressable markets.

But, in early 2022, the Federal Reserve and other central banks hiked rates dramatically. Suddenly, the cost of capital was no longer zero and interest rates, like gravity, began inexorably pulling harder on the sky-high valuations witnessed in late 2021 and early 2022 amongst SaaS businesses.

Figure 1 presents a noteworthy analysis conducted by BVP and is available in full within the 2023 State of the Cloud Report. From left to right:

- **Nov '21:** The critical figures regard the coefficients, shown toward the bottom of the figure, within a 2-factor regression model. Simply put, a model like this uses two variables to try to predict another value—in this case revenue growth and free cash flow margin are the independent variables being used to predict the corresponding valuation impact, the dependent variable. You see 39.8 is roughly 6x 6.3, telling us that a 1% improvement in revenue growth was impacting valuations the same as a 6% improvement in profitability. That's a huge premium focus on showing higher growth!
- **Oct '22:** At this point (the middle chart) we see the relationship flip. Now we are seeing 9.1 is roughly 0.8x of 11.0, telling us that a 1% improvement in revenue growth was impacting valuations the same as a 0.8% improvement in profitability—close to 1-1 relationship and a massive change if we consider how this has to be viewed as a path—and we were all on the journey from something roughly 6:1 favouring growth to now 1:1, where growth and profitability are closer to even.
- **Today (Apr '23):** Currently, we see this relationship defined as a 1% improvement in revenue growth, impacting valuations the same as a 2% improvement in profitability. So, we have our answer—it looks like, roughly speaking, that growth is still important, roughly twice as important as improving profitability, at least within reason.

Figure 1: Growth or profitability? A more quantitative look...

Source: <https://www.bvp.com/atlas/state-of-the-cloud-2023?from=feature>.

Historical performance is not an indication of future performance and any investments may go down in value.

Generative AI: a game-changer

A big portion of the 2023 State of the Cloud Report regards artificial intelligence, specifically how it could be used as an engine to supercharge growth and capability across SaaS companies. BVP believes companies with staying power over the coming decade will have to adopt generative AI features into their offering.

BVP also made references to 'AI native' companies. BVP projects these companies can get to \$1 billion in annual recurring revenue 50% faster than other SaaS companies have achieved in the past.

BVP is focused on annual recurring revenue as opposed to valuation—the market was getting so frothy in the venture space there were simply too many unicorns being minted for the term to maintain its imprimatur of meaning.

Last year, BVP coined the term 'Centaur', meaning a company able to achieve the milestone of 100 million in annual recurring revenue (ARR)—a big deal, and a better show of execution than simply a high valuation.

Only the top SaaS companies with strong execution and remarkable product-market-fit ever see \$1 billion in ARR.

Figure 2: AI native cloud companies could significantly accelerate their path to an important ARR milestone

Source: <https://www.bvp.com/atlas/state-of-the-cloud-2023?from=feature>.

Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.

Conclusion: another way to consider a generative AI exposure?

As of this writing, OpenAI, the company responsible for putting out the viral ChatGPT, is not investable in the public market. Investors seeking exposure to the growth of generative AI, therefore, cannot easily invest in ChatGPT, but they might go about executing this thesis in a variety of ways:

- Certain tech giants, like Microsoft and Alphabet, could be integrating generative AI widely across their very broad, widely adopted platforms.
- For generative AI to work, there could be bigger demand for certain types of semiconductors to accelerate the hardware, so companies like Nvidia may be of interest.
- There are approaches defined by different strategies that may seek exposure to an array of companies representative of a broader AI value-chain or ecosystem.

However, if we learned anything within the tech space during the COVID-19 pandemic, it was the inherent scalability of the SaaS business model. These companies can grow very quickly, and margins can be very, very high. If generative AI becomes a growth catalyst, and it appears that growth is prized amongst SaaS investors, it could have the makings of a very interesting, and different, way to capitalise on an AI growth thesis.

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