

# Contrarian Alert: Is It Time to Look at Software Companies?

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## Key Takeaways

- The market expected quick interest rate cuts in late 2023, leading to a significant drop in the U.S. 10-Year Treasury note yield and a 28.03% return for the BVP Nasdaq Emerging Cloud Index.
- Software-as-a-Service (SaaS) companies underperformed in the first half of 2024, with revenue growth decelerating.
- The focus has shifted to profitability with improved free cash flow margins.

Remember November and December of 2023? The market was expecting a quick series of interest rate cuts from the U.S. Federal Reserve Open Market Committee.

Those looking for a “high duration” equity exposure could say they found it in SaaS companies during this period.

And then the rate cuts, as of this writing, did not come...

## Software Has Faced a Headwind

When we look at how the BVP Nasdaq Emerging Cloud Index has performed for the first six months of 2024, we see a return of -9.38%, during a time when the Nasdaq 100 Index returned 16.98% and the S&P 500 Index returned 14.48%.<sup>3</sup> In short, no one has been impressed with the returns of software stocks.

But returns are one thing—it is harder to look under the hood to get a better gauge of how the companies in software are doing.

## Revenue Growth

The COVID-19 pandemic created an interesting backdrop from which to judge SaaS companies. Many of them were ideally positioned to help companies in other industries stay in business as the environment was changing and different physical restrictions were imposed.

It's also important to remember that one of the main reasons why companies subscribe to software is to generate efficiencies—they're not hoping that the accounting or compliance software is going to make

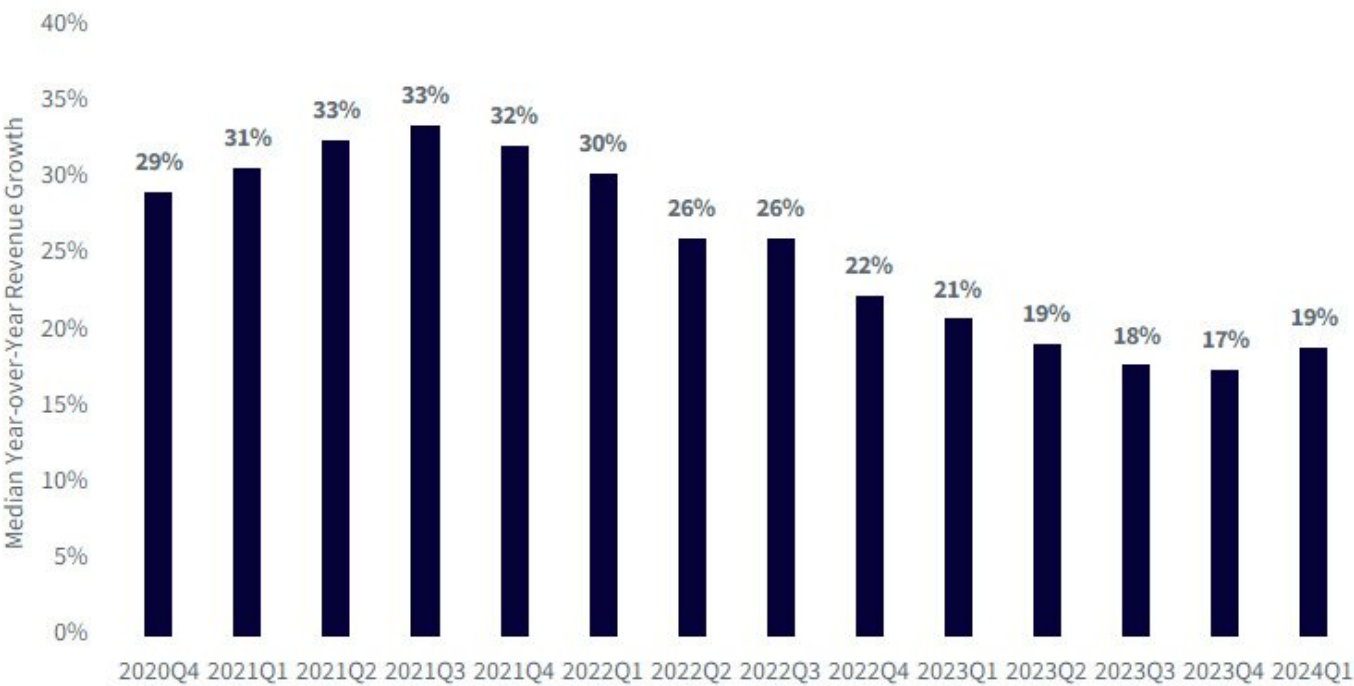
those overall business functions cost even more. While some software packages could be at risk in a more difficult economic environment, others could actually have a tailwind.

ChatGPT, introduced to the world in November 2022, created an entirely new impression as to what software can be used to accomplish. This is another variable that all software companies need to contend with. It isn't just thinking about the value proposition of the individual software package anymore—now it's the value proposition relative to what generative AI software either can do already or may be able to do in the near future.

Against that background, we look to figure 1 to see how the revenue growth of software companies has been:

- The BVP Nasdaq Emerging Cloud Index began its live history in the second half of 2018.
- Median revenue growth was accelerating into the third quarter of 2021. After that point, it went into a decelerating trend, dropping from about 33% to a low of 17%, observed in the fourth quarter of 2023.
- The primary question is whether the fourth quarter of 2023 represented a bottom in median revenue growth for the companies in the BVP Emerging Cloud Index, a measure of SaaS companies, and we are seeing a bit of acceleration in the first quarter of 2024, OR if this is just a blip in a further downward trend.
- Looking forward, the clearest potential positive catalyst for the general “emerging SaaS” company would be actual policy interest rate cuts from the U.S. Federal Reserve. The bigger “unknown” regards how effective each of the SaaS companies will be at establishing its economic value in the face of ever-increasing capabilities from the large language models.

## **Figure 1: BVP Nasdaq Emerging Cloud Index Median Year-over-Year Revenue Growth**

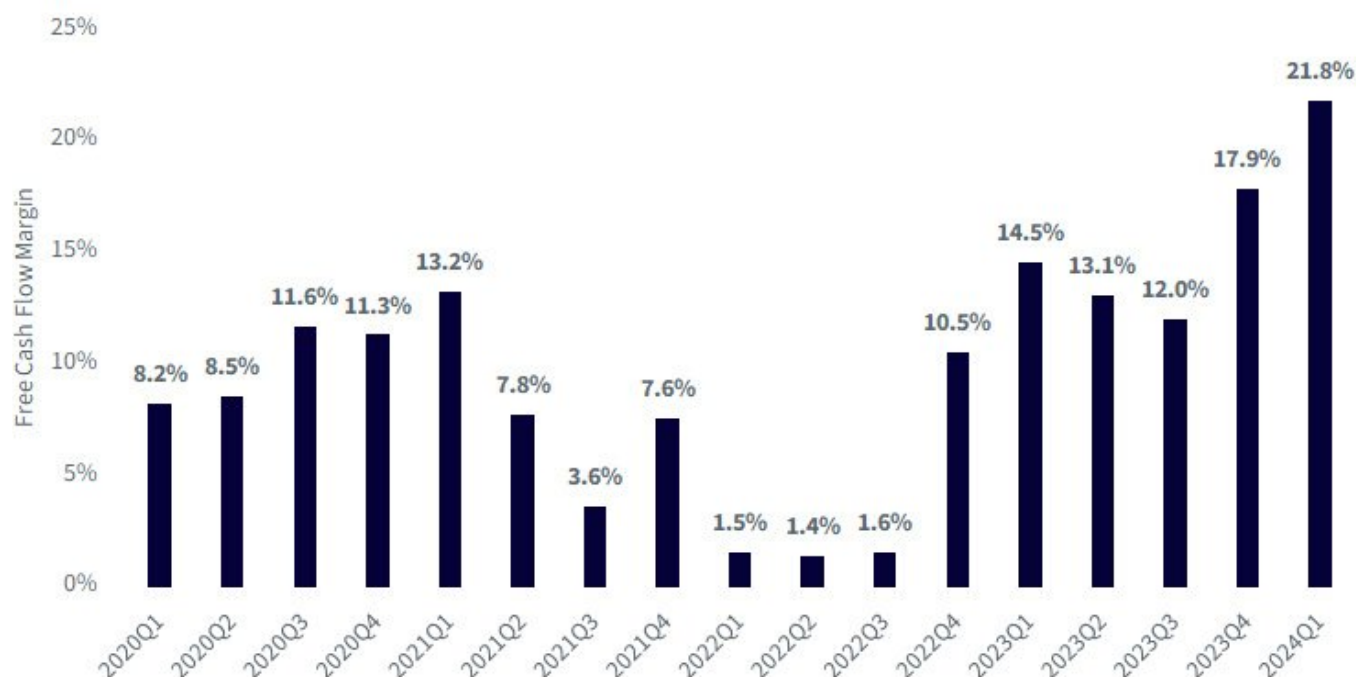


Sources: WisdomTree, Bloomberg, for the period 12/31/20 to 6/30/24. To note, the data for revenue growth based on the period that ended June 30, 2024, has not yet become public and typically begins to become public about one month into the future as companies report their results for the period ended June 30, 2024.

Profitability

Prioritize “growth” or “profitability”? At times, it feels like this is one of the primary questions in evaluating the performance of SaaS companies. When interest rates were at or near zero, and the government was printing more money than it ever had, it was clear that profitability was less important. Currently, in an environment where money market interest rates are hovering around 5%, profitability is more important. As we look at figure 2, the fact is that the median free cash flow margin has gone from 0.9% in the third quarter of 2021 (the peak period in median revenue growth observed in figure 1) to a level of 21.7% in the first quarter of 2024.

Figure 2: Median Free Cash Flow Margin



Sources: WisdomTree, Bloomberg, for the period 3/31/20 to 6/30/24. To note, the data for free cash flow margin based on the period that ended June 30, 2024, has not yet become public and typically begins to become public about one month into the future as companies report their results for the period ended June 30, 2024.

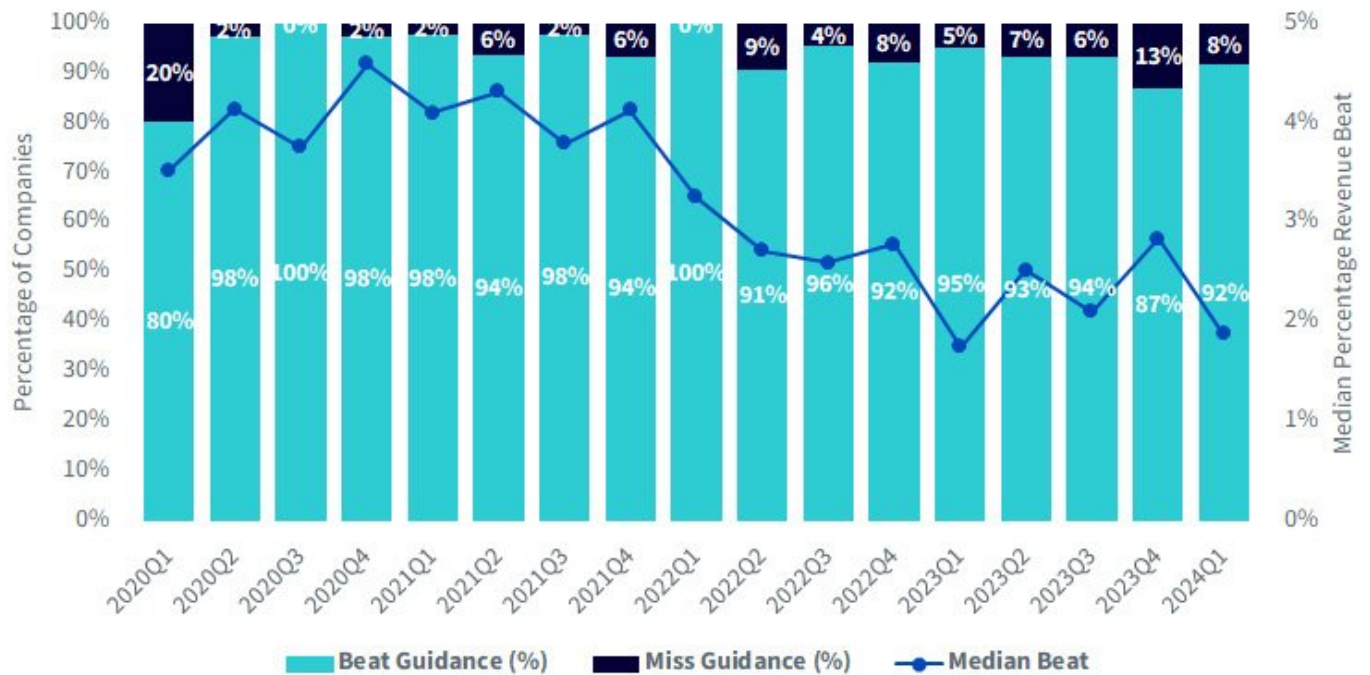
## Can We Learn Anything from the Revenue Guidance?

Much has been written about revenue guidance being a bit of a “game.” Is the goal to genuinely deliver as strong business results as possible, or is the game to simply manage revenue guidance so that it’s possible to say “guidance was beaten”? The reality is probably somewhere on a spectrum.

When we look at the percentage of companies that have beaten guidance, quarter by quarter, in figure 3a, we see that the figure doesn’t change a huge amount. The vast majority of firms within the BVP Nasdaq Emerging Cloud Index have been beating guidance.

Possibly more interesting is the trend in the “median beat,” meaning that a higher number means that the guidance is being beaten by a greater percentage, and a lower number means that the guidance is being beaten by a lower percentage.

- We know that conditions for SaaS companies were better in 2020 and 2021, and we see that the median beat was in the zone of 4%.
- In 2024, conditions are more difficult, and we see that the median beat has ended up around 2%, about half as much.

**Figure 3a: How Companies Are Doing Relative to Guidance**

Sources: WisdomTree, Bloomberg, for the period 3/31/20 to 6/30/24. Median beat denotes the median volume by which reported sales exceed guided sales. To note, the data based on the period that ended June 30, 2024, has not yet become public and typically begins to become public about one month into the future as companies report their results for the period ended June 30, 2024.

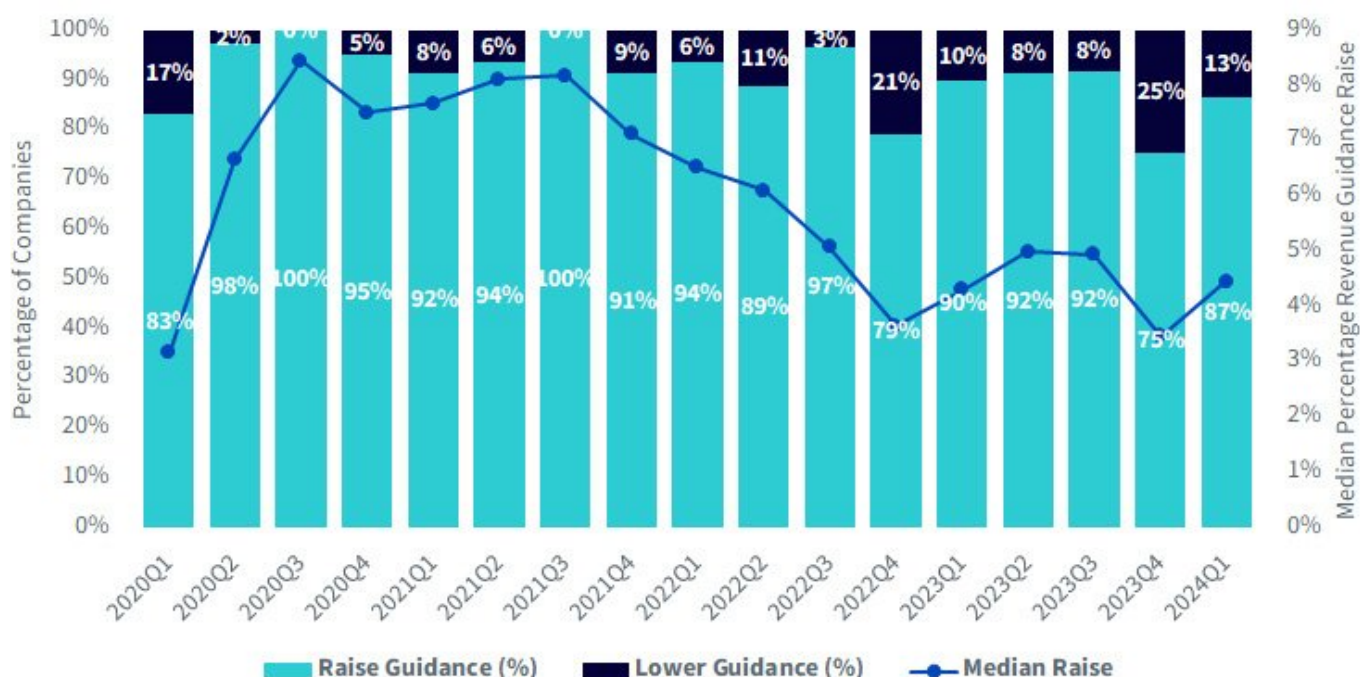
Figure 3b, however, may be more interesting as it relates to companies themselves shifting their guidance. In a sense, we can assume that companies want to provide guidance that they can beat, however slightly, so that the quarterly earnings press release is able to indicate “beating guidance” as opposed to “missing guidance.” If companies are doing this, however, once they know that conditions have changed, they would have to lower guidance in order to be able to turn around and “beat” in the coming quarter.

Every “game” does allow one to at least get a better sense of the score...

The figures do indicate a bit more movement—for instance, in the fourth quarter of 2023, we saw the raise guidance percentage go from 92% to 75%. We also see how the median revenue guidance raise has shifted from the 7%–8% range to something closer to the 4%–5% level.

Conditions may not be as positive as they were in late 2020 and 2021, but the true question is whether the fourth quarter of 2023 will be the toughest point or if the rest of 2024 will be even more challenging.

## Figure 3b: How Companies in the BVP Nasdaq Emerging Cloud Index Are Changing Guidance



Sources: WisdomTree, Bloomberg, as of 3/31/20 to 6/30/24. To note, the data based on the period that ended June 30, 2024, has not yet

become public and typically begins to become public about one month into the future as companies report their results for the period ended

June 30, 2024.

## Conclusion: Is It Contrarian Time?

Sometimes, it makes sense to follow the momentum, which would mean, at least in July 2024, following the trend of some of the world's largest technology companies seemingly ever higher. To be truthful, looking at Nvidia, Apple, Amazon, Microsoft, Meta, Alphabet—it's difficult to know if or when the trend will end. People are citing the difference in return between the S&P 500 Index and the S&P 500 Equal-Weight Index as one measure of the lack of breadth in the market.

Emerging SaaS companies delivered strongly in terms of returns in 2023, but really only when it was assumed that U.S. policy rates were about to be cut. As these cuts did not materialize during the first half of 2024, we saw a very tough performance environment. If it is expected that the U.S. Federal Reserve may move in the second half of 2024, it may be that the trend of the largest companies outperforming shifts and opens up some room for emerging SaaS to exhibit a bit of recovery.

1 Source: Board of Governors of the Federal Reserve System (US), Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/DGS10>, June 27, 2024.

2 Source: Bloomberg.

3 Source: Bloomberg, with the first six months of 2024 referencing December 31, 2023, to June 30, 2024.

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