CLOUD COMPUTING: KEEP LOOKING AT THE GROWTH

Christopher Gannatti – Global Head of Research
12/02/2022

As we write these words, we are roughly halfway through the month of November 2022. Investors globally remain focused on inflation, the policy path of the U.S. Federal Reserve and the earnings reports of individual companies highlighting their results for the quarterly period ended September 30, 2022.

Amongst the many software-as-a-service (SaaS) companies delivering their products through the cloud computing business model, a few narratives are emerging:

- Many, though not all, companies are reporting positive results that beat consensus expectations for the period from June 30, 2022, to September 30, 2022.
- Almost all companies are then guiding expectations downward for the period from September 30, 2022, to December 31, 2022.
- Share price performance—depending, of course, on the macroeconomic announcements happening concurrently—has trended in the downward direction, following the narrative that growth in the current period is slowing and the cloud business model is therefore not immune to a possible recession or generally more difficult economic conditions.

A Tale of Two Companies: Twilio vs. Toast

We can look at the summary results of two companies, very recently reported, that showcase the more general trends.

Twilio: A Great Quarter, but Hammered on the Forward Guidance[1]

For the period ended September 30, 2022, Twilio generated revenue of $983 million, over consensus estimates of $972 million and representing growth of 33% year over year. This was the "good result."

Twilio then noted that 4Q 2022 revenue could be in the range of $955 million to $1.005 billion, which would correspond to year-over-year growth of 18%–19%. However, this would be below the consensus estimate of $1.07 billion. This would be the "lower guidance."

Then, there was this quote from Chief Operating Officer Khozema Shipchandler, noted in a letter to shareholders:

Like many of our software peers, we're seeing negative impacts on our business from the macro environment. As a result of the worsening macro situation, we also feel it is prudent to pull the 30%+ revenue growth target today. We still believe we'll deliver attractive levels of growth going forward, but in the current market, we don't believe 30%+ is achievable.

The day after these results and guidance were made, the share price dropped about 35%. We'd note that Twilio, as a business, is delivering on the same services and mission it was before but has just said that revenue growth expectations have to be more reasonable. While it shouldn't have been as surprising as it was, given the news we see every day, it's also likely exactly the narrative investors do not want to hear, hence the short-term punishment.

Toast: Raising Forward Guidance amidst an Uncertain Macro Environment[2]

There are some companies actually increasing their forward guidance after reporting strong results. Toast fits into this category.

For the full year, Toast raised its expected revenues to a range between $2.692 billion and $2.722 billion from a prior guidance range of $2.2 billion to $2.66 billion. For the quarter set to end December 31, 2022, Toast raised the guidance range to $730 million to $760 million when the consensus expectations were merely $725 million.

For the period ended September 30, 2022, Toast grew revenues year over year by 55%, reaching $752 million. Gross payment volume—noting that this is a key part of Toast's restaurant management software—was $25.2 billion, meaning that the company is now on an annual pace to exceed $100 billion in gross payment volume for the first time.

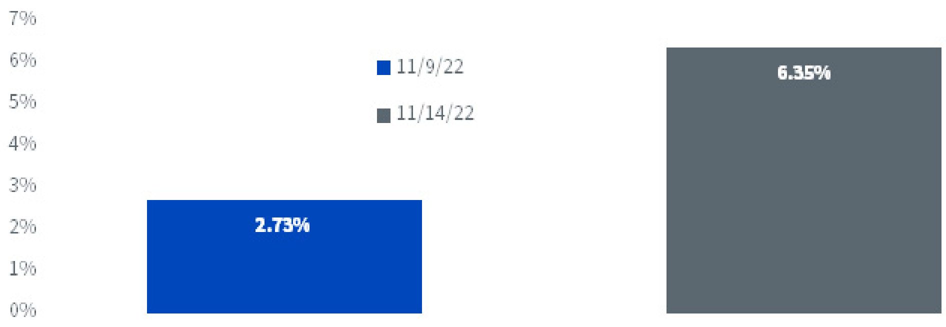
So, it's important to note that not all cloud computing companies are lowering guidance for the current period.

The Bottom Line: Growth vs. Valuation

One year ago, in November 2021, nearly all of our discussions around cloud computing were about the high valuation. We would encourage all investors looking at cloud computing to always try to think of both valuation and growth together. Figure 1 shows a measure of year-over-year sales growth per unit of enterprise value-to-sales multiple, meaning:

- November 9, 2021: The EV-to-sales multiple of the BVP Nasdaq Emerging Cloud Index was 15.17x, whereas the weighted average sales growth was 41.40%. If we divide 41.4/15.17=2.73. Growth was high—but the investor at that time was paying for it.
- November 14, 2022: The EV-to-sales multiple of the BVP Nasdaq Emerging Cloud Index was 4.70x, whereas the weighted average sales growth was 29.86%. If we divide 29.86/4.70=6.35. The multiple has dropped a lot, and while the growth has decelerated, the valuation decelerated at a faster rate. The investor is now getting more units of growth for less money than they paid for those units of growth roughly one year ago.

Figure 1: Year-over-Year Sales Growth per Enterprise Value-to-Sales (EV-to-Sales) Multiple



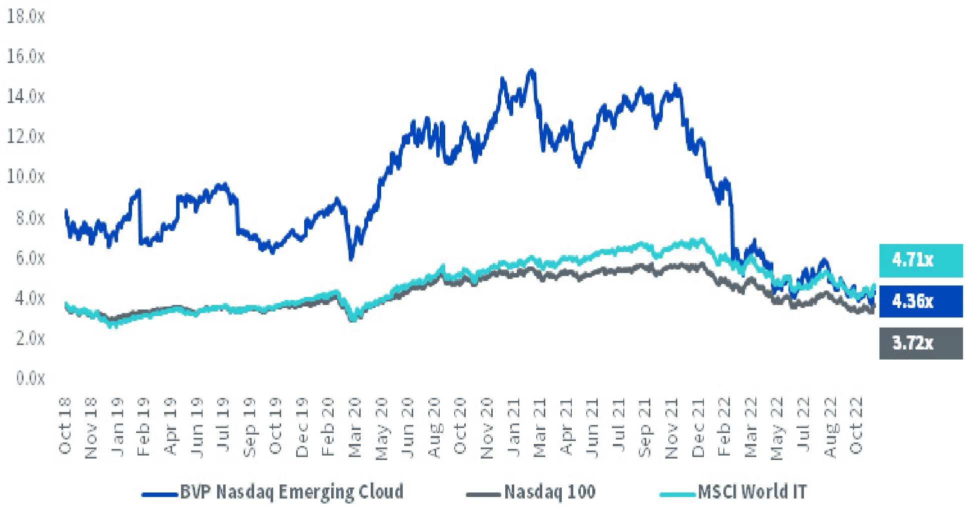
Sources: WisdomTree, Bloomberg. All fundamentals data is from Bloomberg. EMCLOUDN is the BVP Nasdaq Emerging Cloud Index. In the calculation of presented metrics, the underlying Index constituents and weights are fixed as of November 14, 2022, and only fundamentals data is changing. Sales growth is represented by a weighted average sales growth of the Index constituents. Sales growth for the underlying constituents is computed year over year from quarterly, semi-annual or annual data, based on whichever is available in Bloomberg, starting from quarterly data. EV-to-sales is represented by a weighted harmonic mean of the EV-to-sales for the Index constituents. EV-to-sales for the underlying constituents is represented by a ratio of enterprise value (EV) over trailing 12-month sales. You cannot invest directly in an index.

The Path = Our Emotional Memory

Investors don't "feel great" when we speak to them, generally, about their tech investments, their growth investments or their software investment in 2022. This is not because the world isn't using tech or software, but rather, it is because these stocks have rapidly adjusted—through massive multiple contractions—to the shift we are all watching from 0% interest rate policies to much higher interest rate policies at various developed market central banks.

But, as we see in figure 2, if we can reset our thinking, starting from the present period, we can see that the BVP Nasdaq Emerging Cloud Index is trading at a valuation that is quite similar to the more general, broad tech benchmarks, such as the Nasdaq 100 Index or the MSCI World Information Technology Index. If these cloud companies can hold on to faster growth than the broad tech markets, this creates an interesting opportunity for investors with longer time horizons.

Figure 2: Historical Price-to-Sales Ratio since Live Inception of the BVP Nasdaq Emerging Cloud Index



Sources: WisdomTree, Bloomberg. Period from 10/2/18 to 11/14/22. Historical price-to-sales ratio data is from Bloomberg. You cannot invest directly in an index.

Conclusion: It's All about the Growth

Cloud companies need to weather the macroeconomic storm of the present period, and those that are able to hang on to their ability to showcase growth will be well positioned for what many are calling the coming "pivot." We don't know exactly when the U.S. Federal Reserve will stop raising interest rates, but we are seeing—just look at the performance observed on November 10 and 11, 2022—that the market is keyed into anything that appears even remotely helpful in the case for less tightening. We believe that the long-term picture will be determined by the capability of companies in the BVP Nasdaq Emerging Cloud Index to continue to grow, even if the short-term picture may be more determined by movements in interest rates and interest rate expectations. Those investors looking to implement an investment may consider more closely studying the WisdomTree Cloud Computing ETF (WCLD), which is designed to track the returns of the BVP Nasdaq Emerging Cloud Index after accounting for fees and expenses.

Christopher Gannatti is an employee of WisdomTree UK Limited, a European subsidiary of WisdomTree Asset Management Inc.'s parent company, WisdomTree Investments, Inc.

As of November 21, 2022, WCLD held 1.08% and 1.66% in Twilio and Toast. Click here for a full list of Fund holdings. Holdings are subject to change

[1] Source: Eric J. Savitz, "There's New Trouble Brewing in Cloud Stocks. Twilio and Atlassian Issue Growth Warnings," Barron's, 11/4/22.

[2] Source: Emily Dattilo, "'Toast Is On Fire' as Management Lifts Outlook. The Stock Is

Higher," Barron's, 11/11/22.

Important Risks Related to this Article

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You cannot invest directly in an index.

DEFINITIONS

Inflation : Characterized by rising price levels.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Software-as-a-Service (SaaS) : Software applications provided over a network connectio.

Cloud deployment model : There are four cloud deployment models: public, private, community, and hybrid. Each deployment model is defined according to where the infrastructure for the environment is located. There are three main cloud service models: Software as a Service, Platform as a Service, and Infrastructure as a Service.

Macro : Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

Gross payment volume : The total monetary value of transactions that pass through a payments system (Merchant, Payment Facilitator, Payment Processor, etc.) within a defined period of time.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Enterprise Value-to-Sales (EV/Sales) : A financial valuation measure that compares the enterprise value (EV) of a company to its annual sales. The EV/sales multiple gives investors a quantifiable metric of how to value a company based on its sales while taking account of both the company's equity and debt.

BVP Nasdaq Emerging Cloud Index : designed to track the performance of emerging public companies primarily involved in providing cloud software to their customers.

Multiple compression : An effect that occurs when a company's earnings increase, but its stock price does not move in response.

Nasdaq 100 Index : Includes 100 of the largest domestic and international non-financial companies listed on The Nasdaq Stock Market based on market capitalization. The Index reflects companies across major industry groups including computer hardware and software, telecommunications, retail/wholesale trade and biotechnology. It does not contain securities of financial companies, including investment companies.

MSCI World Information Technology Index : Measures the performance of the technology sector in developed equity markets.