

WHAT WE LEARNED FROM BVPS "STATE OF THE CLOUD" 2023

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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](#), called EMCLOUD, and this index is tracked by the [WisdomTree Cloud Computing Fund \(WCLD\)](#).

The following two areas in the BVP 2023 *State of the Cloud* report particularly caught our attention:

1. **Profitability vs. growth tug-of-war:** People like simpler answers. But for an SaaS business choosing profitability or growth, it is best to think of it like a slide rule along a spectrum—the middle signals both are equally important, while over time, the slider moves to one side or the other depending on the market's preference. BVP's analysis helps visualize how this slide rule has been moving around.

2. **Artificial intelligence (AI):** Particularly in the context of the large language models (LLMs) that characterize state-of-the-art 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 SaaS companies should be among the best beneficiaries.

To Focus on Growth or Profitability...Understanding the SaaS Slide Rule

For the majority of time between the [2008-09 global financial crisis](#) and 2022, the [Federal Reserve](#) set its [Federal Funds Rate](#) very close to zero, creating an historically low [cost of capital](#) for all companies in the U.S. 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.

In 2022, the Fed 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 among SaaS businesses.

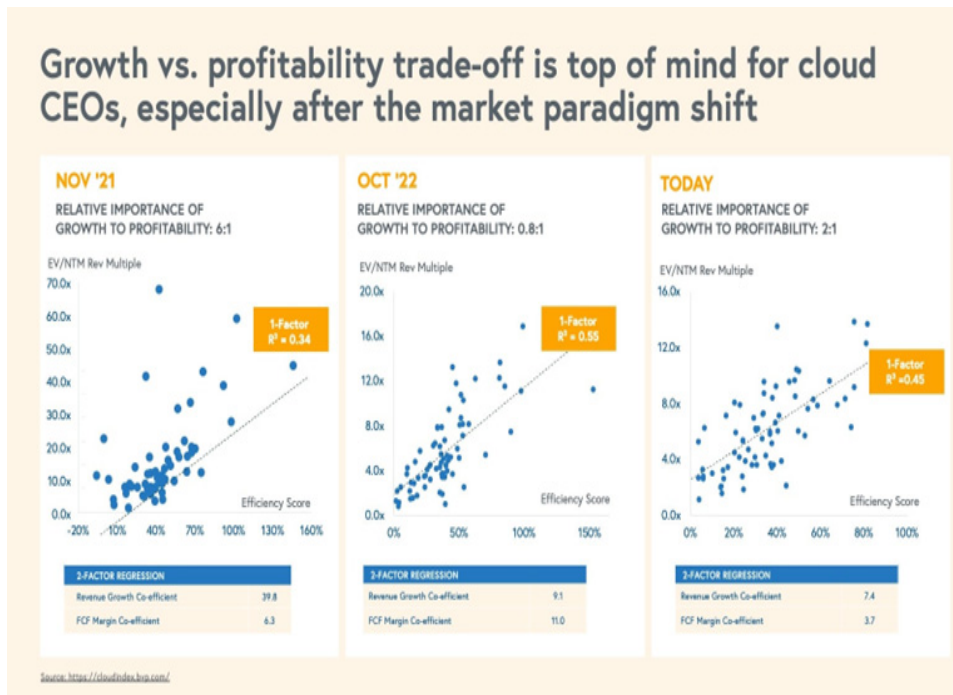
Figure 1 presents a noteworthy analysis done by BVP and available in full in the 2023 *State of the Cloud* report. From left to right:

- 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 favoring growth to 1:1 now, where growth and profitability are closer to even.

- **Today (Apr '23):** Currently, we see this relationship defined as a 1% improvement in revenue growth was 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: Bessemer Venture Partners, as of 4/10/23.

Generative AI: A Game-Changer

A big chunk of the 2023 *State of the Cloud* report discussed 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.

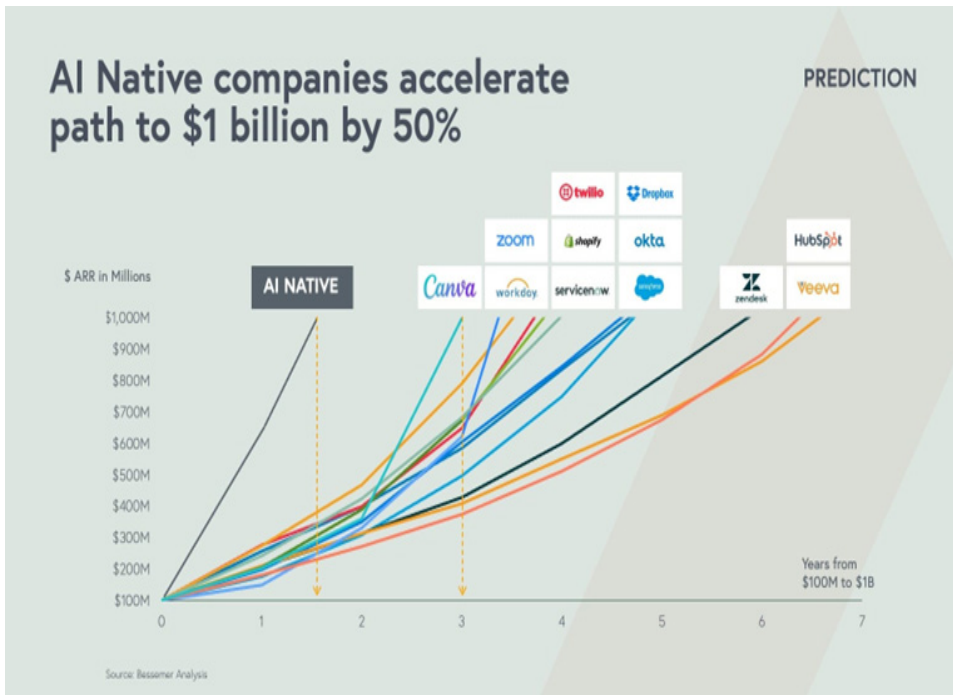
BVP also made reference to ‘AI native’ companies. BVP projects these companies can get to \$1 billion in annual recurring revenue 50% faster than other SaaS companies achieved in the past.

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 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: Bessemer Venture Partners, as of 4/10/23.

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 demands for certain types of semiconductors to accelerate the hardware, so companies like Nvidia may be of interest.
- There are ETFs, like the [WisdomTree Artificial Intelligence and Innovation Fund \(WTAI\)](#), that seek a diversified exposure to the AI 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 among SaaS investors...it could have the makings of a very interesting, and different, way to capitalize on an AI growth thesis.

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DEFINITIONS

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

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

Artificial intelligence: machine analysis and decision-making.

The Global Financial Crisis: Refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

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

Federal Funds Rate: The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

Weighted average cost of capital (WACC): The average rate that a business pays to finance its assets. It is calculated by averaging the rate of all of the company's sources of capital (both debt and equity), weighted by the proportion of each component.

Free Cash Flow: A measure of how much cash is left in the company after taking into account all the necessary expenses, including net capital expenditures.

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.

Unicorn: The term unicorn refers to a privately held startup company with a value of over \$1 billion.