Global Technology
CLOUD COMPUTING: STILL IN ITS EARLY STAGES AND SPREADING GLOBALLY

KEY POINTS

- In our view, cloud computing—a term that describes on-demand computing power, applications, and services offered on a subscription model—is a well-established trend with multiple years of growth ahead.

- Cloud computing results in both a significant reduction in a company’s investment in hardware and software, as well as subsequent cost savings on information technology (IT) staff that would be needed to maintain those resources.

- Increased demand for products and services, including streaming video services and augmented reality, should increase demand for cloud infrastructure and services.

- Our global research platform has helped us to identify the key characteristics that can lead to successful outcomes among cloud computing companies, and we have selected enterprises that we believe are successfully innovating and expanding market share.

WHY COMPANIES HAVE THEIR HEADS IN THE CLOUD

For years, companies needed to install servers and software on site to meet their various computing needs. This technology required expensive maintenance and routine upgrades. Much to the dismay of corporate leaders, there was no other option. Now, cloud computing offers a more customer-friendly solution—one that is disrupting the technology landscape.

Providers of cloud computing services host hardware and applications from their own data centers, and customers access their offerings through the Internet and a broadband connection. These companies offer on-demand computing power or software to customers via the cloud. These avenues result in both a significant reduction in a company’s investment in hardware and software, as well as subsequent cost savings on IT staff that would be needed to maintain those resources.

COST SAVINGS AND INCREASED EFFICIENCIES

To better illustrate the benefits of and growing appeal for on-demand computing power, it helps to look at the biggest player in this area: Amazon.com’s Amazon Web Services (AWS). Launched in 2006, AWS has experienced rapid growth. Its revenues of less than USD $1 billion in 2011 jumped to over USD $12 billion in 2016. AWS’s scalability allows companies to pay for only the amount of server capacity that they use, effectively ending the days of idle capacity. AWS and similar cloud-based infrastructures and platforms, like Microsoft’s Azure and Alibaba...
Group Holding’s AliCloud, help facilitate e-business, big data analytics, enterprise applications, and many other functions.

On-demand computing power allows firms to focus on their core competencies rather than diverting resources to maintain in-house technology. In fact, we’re witnessing more and more businesses run their operations entirely through the cloud. Netflix and Airbnb are two prominent examples. Netflix began its migration to the cloud in 2008 following a database corruption that prevented it from shipping DVDs for three days. The cloud has helped support its rapid growth and expansion into international markets because the company would have likely struggled to add servers quickly enough to keep pace with its ever-increasing capacity needs. As one might expect, companies like Airbnb that were born into the cloud era tend to reap the benefits of cloud computing earlier and, at least initially, to a greater degree than traditional legacy technology firms.

The cost savings and increased efficiencies cloud computing offers cannot be understated. In our meetings with management teams across the technology sector and in other sectors, we’ve consistently heard that cloud computing models can lead to significant cost and operational efficiencies. Over the past five years, we’ve noted that companies have increasingly adopted a “cloud first” strategy, as more businesses demonstrate an interest in opting for cloud services versus on-site options. A recent survey released February 2017 of more than 2,000 IT professionals conducted by antivirus software company McAfee found that over 80% of businesses surveyed are now adhering to a “cloud first” strategy.

FROM LICENCES TO SUBSCRIPTIONS

Other cloud computing firms deliver applications and services via the cloud. For example, a retailer might decide that it wants to use social media as a means to resolve customer issues and complaints. Several leading providers of enterprise software-as-a-service (SaaS) are helping companies more strategically track and respond to customer posts. In addition, a human resources department can manage its employees’ payroll and benefits needs through a cloud-based subscription service. It can renew the subscription as needed rather than paying for licensed software or other IT tools. This emerging subscription-based model provides companies with a new level of flexibility, while also cutting internal IT costs.

Salesforce.com and Workday are among two major players. Salesforce is a leading SaaS provider, with the
majority of its revenue derived from customer relationship management applications. Salesforce’s strong front-office product portfolio and highly recurring subscription business model should help it become a major beneficiary of the trend toward SaaS. We are mindful, however, that the company’s operating margins are lower than some of its peers.

Workday helps enterprises manage labor resources and firms’ financial information. Most of Workday’s revenues come from human resource applications. We believe that its platform is highly versatile and differentiated, making it a very durable software company. However, we continue to be mindful of valuation and changes to the stock’s risk/reward profile. Our expertise in investing in these software companies helps us effectively assess their valuation and others like them because we understand what the steady state of operating margins should be for a software company when it is fully scaled. Additionally, our insights into the how much value each new customer will add assist in our evaluation of a company’s decision to expand.

INCREASED COMPUTING POWER DRIVES NEXT GENERATION OF APPLICATIONS

Increased demand for products and services like streaming video services and augmented reality should in turn increase demand for cloud infrastructure and services. This demand can be illustrated by the fact that, each day, AWS adds the cloud capacity necessary to support a Fortune 500 enterprise.

Cloud computing models are well equipped to further innovate and provide solutions to existing and burgeoning industries. We’re witnessing this today with edge computing, which allows for data workloads to be processed closer to the source of the data. Edge computing will be instrumental in the widespread adoption of autonomous vehicles because these cars and trucks generate approximately one gigabyte of data every second—an amount that would overwhelm current network bandwidth if many self-driving vehicles were operating in a given area. For this reason, companies developing these vehicles envision them as hardware and servers on wheels. Advances in on-demand computing power will increase a firm’s ability to make use of all the unstructured data that are gathered daily.

GLOBAL MIND-SET FOR A GLOBAL TREND

A key advantage of investing across the globe is that we can apply what we learned in one market to other markets. Our ability to effectively evaluate business models transfers well to all regions. For example, Alibaba Group Holding, one of the largest e-commerce companies in the world, embodies many appealing characteristics. Its retail share in China accounts for roughly three-quarters of online sales in the country. Alibaba Group Holding, the company’s cloud business, has scale and network effects that are reminiscent of a younger AWS. Unlike Amazon.com in 2006, Alibaba Group Holding will not need to pitch the benefits of cloud computing to potential customers since these are now well known. Over the long term, we believe that AliCloud should have better economics than the company’s e-commerce business. Furthermore, Alibaba Group Holding operates in a market with reduced competitive headwinds from foreign companies. That being said, cloud computing adoption is still in its early stages within the region, and we acknowledge that AliCloud is likely to encounter unforeseen challenges in its push for widespread adoption.

Finally, we believe that Alibaba Group Holding is transitioning into one of the global leaders in the collection and utilization of data. In our opinion, data, computing power, and talent will determine which companies emerge as winners in developing the next generation of artificial intelligence applications. Alibaba Group Holding’s scale is much larger than that of its U.S. counterparts.

CONCLUSION

In our view, cloud computing is a well-established trend with multiple years of growth ahead. Investing in cloud computing requires a deep understanding of the industry and how emerging trends and innovations will leverage—and even change—this technology. We believe our bottom-up approach to stock selection coupled with our firm’s global capabilities uniquely help us to identify cloud computing companies that are best positioned to achieve meaningful growth.
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