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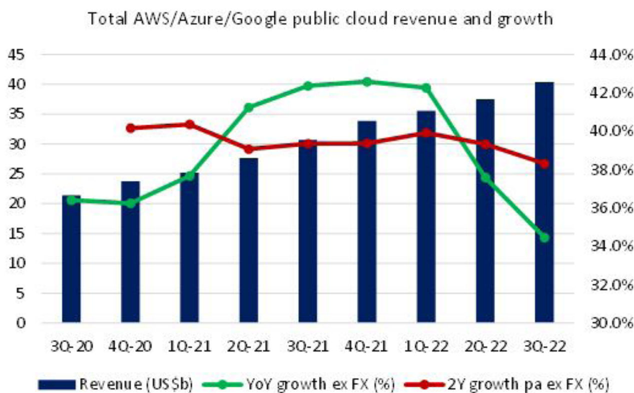
EXPERTS IN GLOBAL INVESTING

Why the cloud investment opportunity will outlast an economic downturn

The global shift to cloud computing is a seismic and transformational trend that we have backed for several years at Magellan.

For the hyperscale public cloud vendors outside China – Amazon, Microsoft, and Google (the Magellan Global Fund holds all three companies) – it has created unprecedented market opportunity. These vendors have consistently generated strong double-digit revenue growth at scale and continue to do so to this day. Yet in the most recent two financial quarters, hyperscale cloud revenue has faced decelerating growth as enterprise customers reign in spend amid the uncertain macroeconomic backdrop. Has the story come to an end?



Note: Blue bars represent aggregate quarterly cloud revenue of Amazon Web Services, Microsoft Azure (MFG estimate), and Google Cloud. Green line represents the quarterly year-over-year growth rate. Red line represents the growth rate compared to two years ago on an annualised basis. Growth rates are in constant currency to reflect underlying growth.

The trend this year is apparent. Excluding the impact of currency movements, hyperscale cloud revenue grew in aggregate 42% year-over-year in Q1. In Q2, the growth rate fell to 38%, and in the most recent Q3, the growth fell further to 34%. The two largest vendors, Amazon and Microsoft, expect this deceleration to continue, which means we should expect growth to slow again in Q4. On top of that, margins are falling, with both companies dealing with rising energy costs in their data centres while continuing to maintain their pace of double-digit operating expense growth. All of this may seem dire but let us unpack it further.

We start by recognising that the deceleration this year appears more severe because it is being compared to several quarters of strong growth in 2021 due to cloud demand created by the pandemic responses. To try to adjust for this by looking at this year's quarterly growth rates on a 2-year annualised basis, we see a steadier growth trend, albeit one that is still slowing – from 40% in Q1, to 39% in Q2, to 38% in Q3. (The fact that we are seeing this type of growth on an aggregate US$160 billion in annualised revenue is staggering on its own). These decreases are more marginal and subject to noise, but there is broader evidence that IT spend is generally tightening.

The unfavourability of these recent IT spending trends are, we believe, cyclical not structural. Market uncertainty has compelled enterprise customers to become more prudent or selective about their IT investments. Some customers are in industries facing challenges of their own such as supply chain issues, inflation, or labour shortages. We also expect some spend was driven by the period of excessive cheap, available money and this spend will not return. And as their customers seek to tighten their belts, hyperscale cloud vendors are taking it a step further and in fact helping customers to improve the efficiency of their spend (e.g., through lower priced options). In other words, the cloud vendors are effectively contributing to their own growth headwinds.

Why do this? It is about driving trusted partnerships with customers for long term growth, rather than short-sightedly focusing on maximising growth today. This makes sense if one believes, as we do, that cloud has a significant multi-year growth runway ahead. In fact, the ability for customers to proactively dial up and down cloud spend according to their needs – rather than being burdened with the large, fixed costs of an on-premises data centre when times are tough – is one of the fundamental value propositions of the cloud, and the current environment reinforces this validity. Put another way, hyperscale cloud is doing exactly what it was meant to do.

The effect of rising energy costs on the hyperscale cloud vendors has been negative but comparably modest so far. Amazon cited a 200bps impact to AWS margins in aggregate over two years, and for Microsoft we expect an impact of less than 100bps to its cloud margins this financial year, unless costs rise significantly higher. The cloud vendors are absorbing these higher costs in the near term, but we believe they possess the pricing power to share rising costs with customers over the longer term. An underappreciated point is that the energy efficiency of hyperscale

data centres is far superior to what customers can achieve on their own, which is further demonstrating to these customers the advantages of being in the cloud.

Cloud computing is proving its value to customers as much in this environment as it ever has, and we can see this when we delve beyond the quarterly headlines. It is why we continue to view this investment opportunity as compelling on the longer time horizon. It is an attractive, enduring, and multi-year opportunity that will deliver robust growth and attractive margins on the other side of the economic cycle we find ourselves in today.

By Adrian Lu, Investment Analyst

Sources: Company filings and Magellan estimates.

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