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Postcard from San Francisco

We believe tech exposure will begin to look very interesting in the next 12 months

Winston Chong and Michelle Byun 4 April 2023

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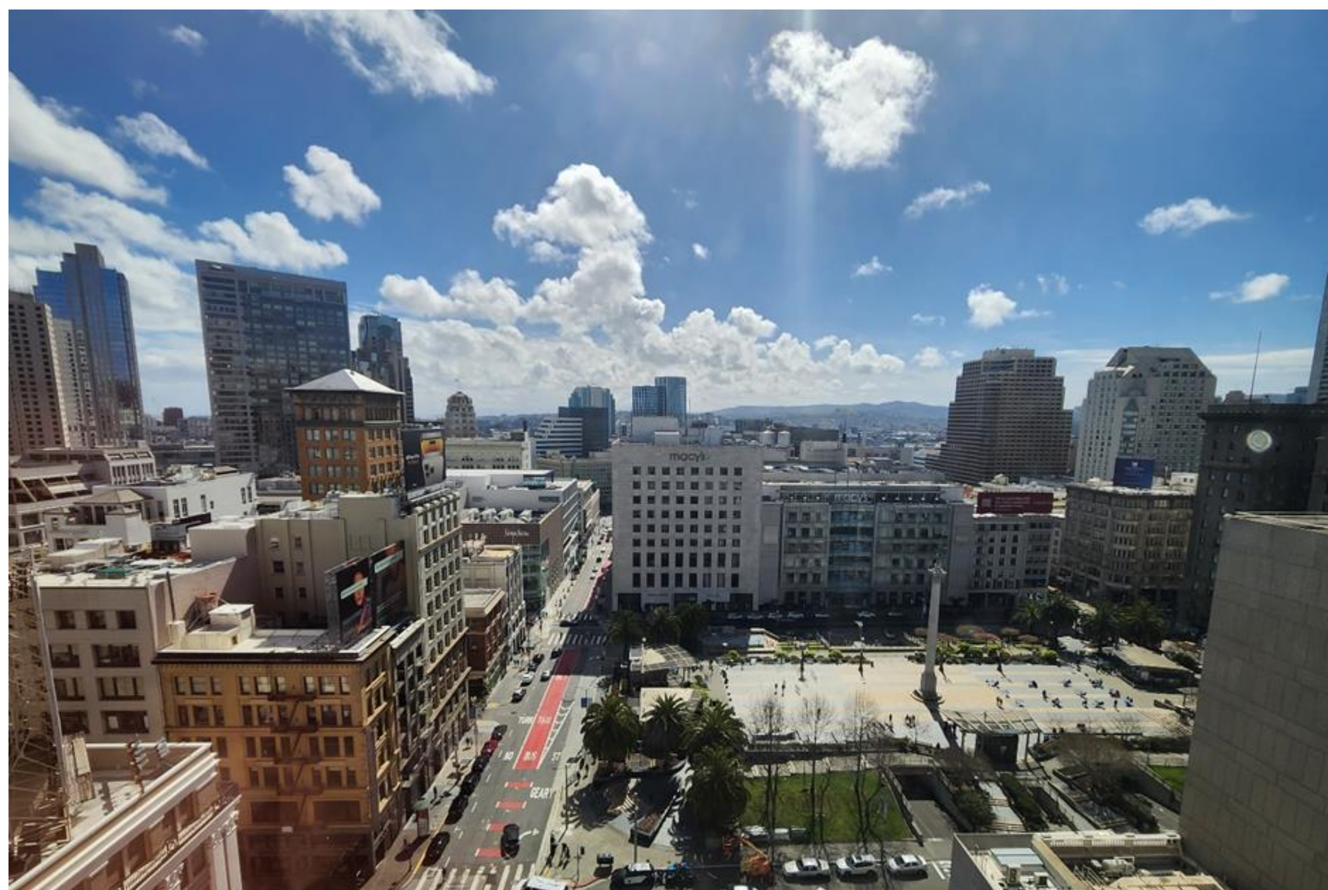
Last month, we travelled to San Francisco to meet with several technology companies. One of the key themes running through our meetings was productivity, efficiency and cost reduction as the tech industry seeks to drive growth in an environment where enterprise spending is slowing and capital is scarcer. The failure of Silicon Valley Bank which occurred while we were over there served to amplify this focus and was a stark reminder to companies that the current time is one of consolidation and focus.

Figure 1: Union Square, San Francisco – it was cold, but sunny!

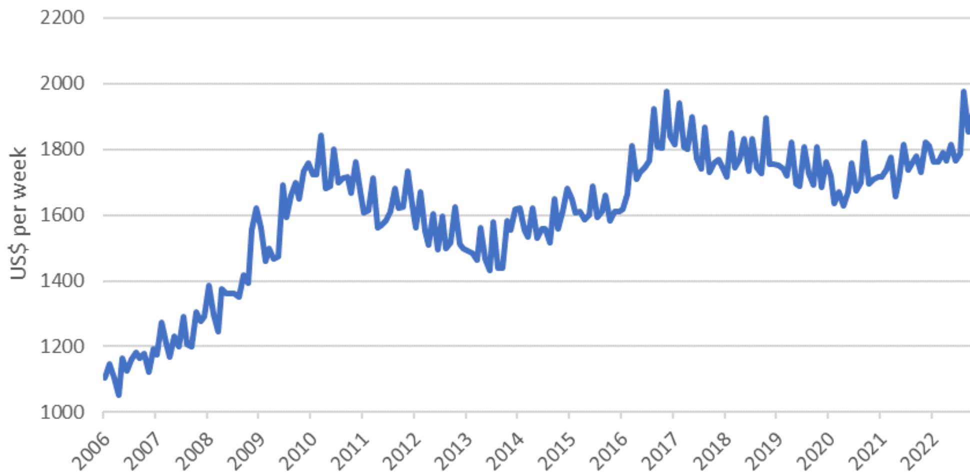


Source: Antares Equities; March 2023

Laying off the "growth at all costs" mindset in tech

Prior to 2022, the consistent feedback we had heard from tech companies was the increasing difficulty in finding people to employ into the tech sector which had led to higher wages for the likes of software engineers. At a time where capital was cheap, tech companies were happy to pay up for talent and were becoming increasingly indiscriminate about investment and pursuing all kinds of longer-term projects with unknown returns.

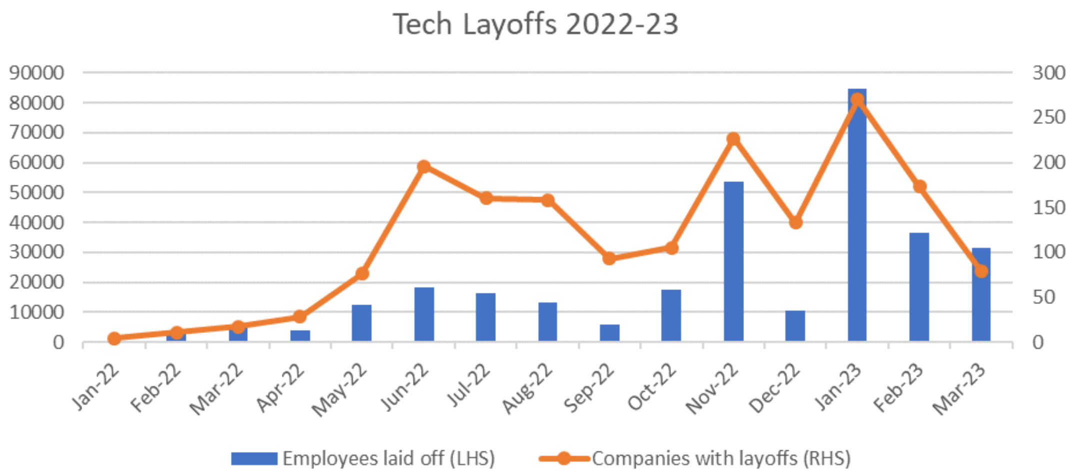
Figure 2: US average weekly earnings – computer & software employees



Source: US Bureau of Labour Statistics, March 2023

From 2022 we began to see an increase in layoffs in the US tech sector. The advent of higher interest rates made capital that was previously abundant scarcer and pushed the discount rates used to value these companies higher. This was most pronounced in cash flow negative, venture capital (VC) backed companies which started to rein in costs to bring forward cash flow breakeven targets to ensure their financial sustainability. Whilst in the early part of 2022 the cuts were concentrated in these earlier stage firms, the latter part of 2022 and early 2023 has seen larger, profitable tech companies cut discretionary spend on moonshot ideas as the "growth at all costs" mindset has shifted towards one of efficiency. This phenomenon is not just confined to the US, and we have seen similar moves by a number of Australian companies (Atlassian, Xero, Megaport).

Figure 3: Global tech layoffs since COVID-19



Source: Layoffs.fyi, March 2023

A new and necessary era of discipline in tech

Our view coming away from San Francisco is that layoffs and hiring freezes are likely to continue. Some of the larger companies such as Meta and Amazon are already up to their second round of cuts in six months. It is easy to see why management teams are behaving this way at a time when investors are becoming more focused on profitability. A simplistic way of looking at this is in the current environment for a software company with 50% margins, management can grow earnings by $1 by either:

- pursuing $2 of growth in an environment where enterprise spending is tighter (assuming incremental margins are also 50%); or
- cutting $1 of operating expenditure and immediately booking the benefit.

The question here is – which is a better way to grow profit?

Ruth Porat, CFO of Alphabet was quoted back in 2015 saying “you can’t cost cut your way to greatness”, yet in January 2023 the company laid off 12,000 workers and flagged further cuts.

The reason we believe companies will continue to cut is that to date, there has been limited impact on product quality or revenue. Part of the reason for this may be timing, however a large part is likely also the fact that tech has been through a large boom during the low interest rate era. We see parallels with other industries that became “fat” during boom times – think oil & gas when energy prices are high, resources companies during the mining boom, retailers during the pandemic. At times when revenue growth is not an issue, companies tend to become less disciplined. Inevitably when growth subsides, they go into cost cutting mode and come out the other side leaner, more efficient and disciplined. As a result they are in a strong position to generate substantial cash flow and earnings once the demand environment picks up.

Opportunities may emerge

It is for this reason that we believe tech exposure will begin to look very interesting in the next 12 months. Tech companies themselves are enablers of efficiency. Whilst the current business environment is seeing take-up for their products and services slow, given the essential nature and value-add many software companies provide to their end customers, we believe that growth opportunities for several tech companies remain intact. What is important is that they keep investing. Moreover, in a lower growth environment there are several tech companies we can think of that have pricing power which enables them to continually reinvest in growth. Many of the companies we met with had increased prices substantially in the last 12 months, in many cases the first time in 10+ years, without any loss of customers.

Balancing profitability and growth

A key question we asked tech companies we met with as they undertake cost cutting exercises is what exactly is being cut? By and large our meetings suggested that they have been in areas such as sales and marketing, moonshot projects, corporate headquarters and other areas of overinvestment. Many companies also see opportunities for their workforce to be more productive. Every company we met with had moved to “work from anywhere” which presents cultural challenges but also gives companies the opportunity to consolidate office space.

The longer-term question is whether these cuts result in more profitable but lower growth outlooks for these companies, or can they deliver both (i.e. be more profitable and maintain strong topline growth over the medium to long term)? When we asked management teams about their philosophy on the trade-off between top line growth and profitability, most conceded the scales had tilted more towards profitability in the last six months. However, all executives strongly believed that a combination of the two was the key to long term value creation. We came across two ways in which companies were thinking about this:

1. demonstrating modest operating leverage year on year and reinvest the remainder in growth; and
2. managing the business to a rule of 40 or above (see explanation below).

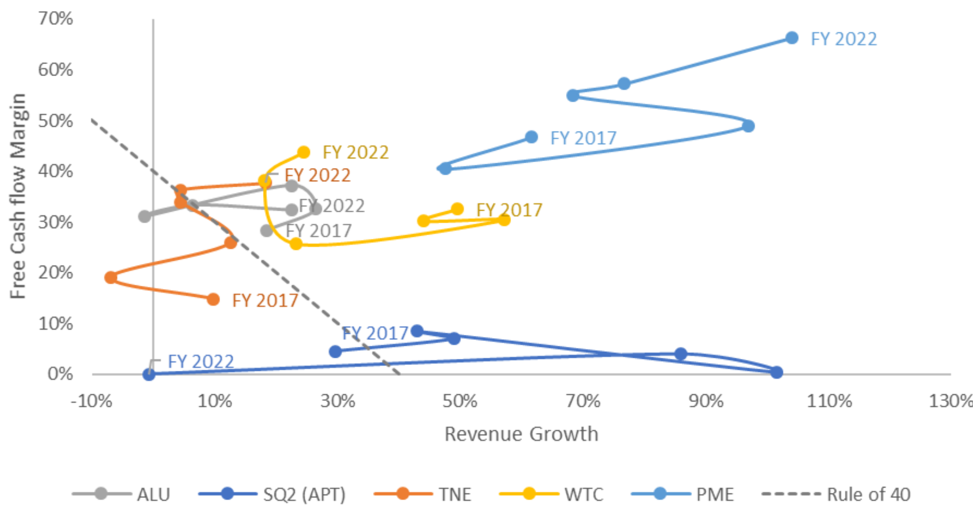
The Rule of 40

The “Rule of 40” is a principle popularised by venture capitalists in 2015 as a high-level health check for SaaS (Softwares as a service – cloud based subscription solution) companies, but has been more broadly applied to software companies. The metric seeks to capture the tradeoff between near term profitability and investing in top line growth. Specifically, it dictates that a “healthy” company should deliver revenue growth plus free cash flow (or EBITDA) margin equal to 40% or more.

A study by Bain & Company in 2018 found that whilst in a single year 40% of publicly traded US software companies outperformed the rule of 40, only 25% and 16% of companies outperformed the rule of 40 over three and five years, respectively. Naturally, these companies also saw substantial share price outperformance where the rule of 40 was sustained.

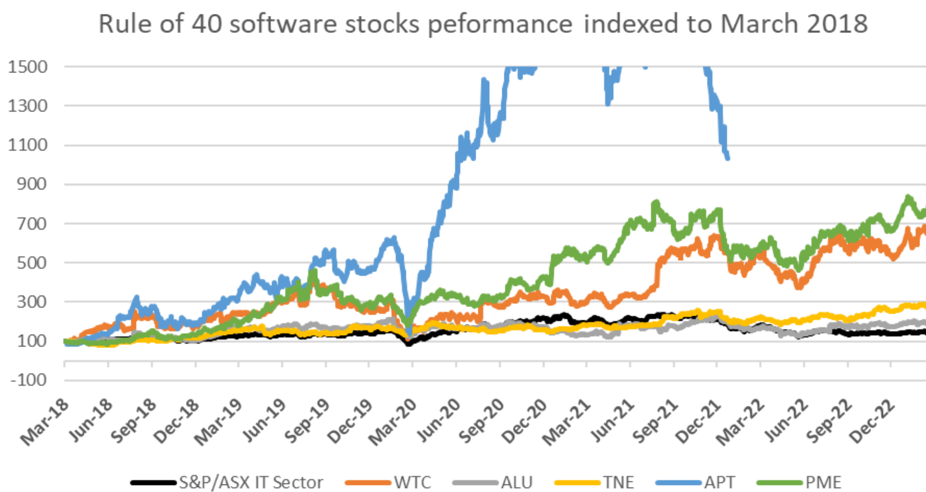
This phenomenon is also true in Australia – we have identified five software companies on the ASX that have (more or less) consistently delivered on the rule of 40 over FY17-22: Wisetech (WTC), Altium (ALU), TechnologyOne (TNE), Block/Afterpay (APT) and Promedicus (PME). Coincidentally all these companies have outperformed the S&P/ASX200 Information Technology Sector Index on a 5 year time frame.

Figure 4: ASX listed software companies that have consistently delivered on the Rule of 40



Source: Bloomberg, Antares Equities; March 2023

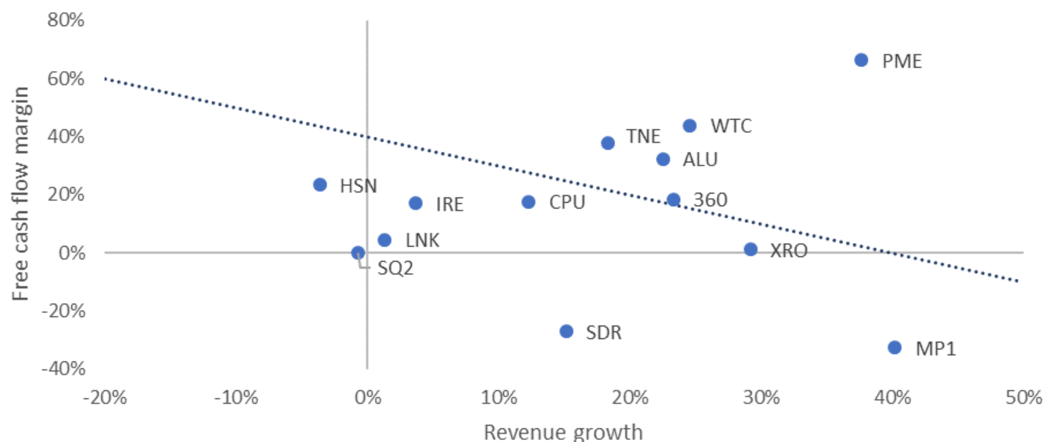
Figure 5: Performance of ASX listed Rule of 40 stocks indexed to March 2018 (5 yrs) vs IT Sector



Source: Bloomberg, Antares Equities; March 2023

The rule of 40 is an interesting take on the current environment where tech companies are looking to increase margins and can be a good measure of whether they are doing so in a way which keeps their growth intact. This is something that has been on our mind at Antares and we have recently surveyed the Australian tech companies to see where they are sitting against the rule of 40 benchmark.

Figure 6: Australian software companies vs rule of 40 in 2022



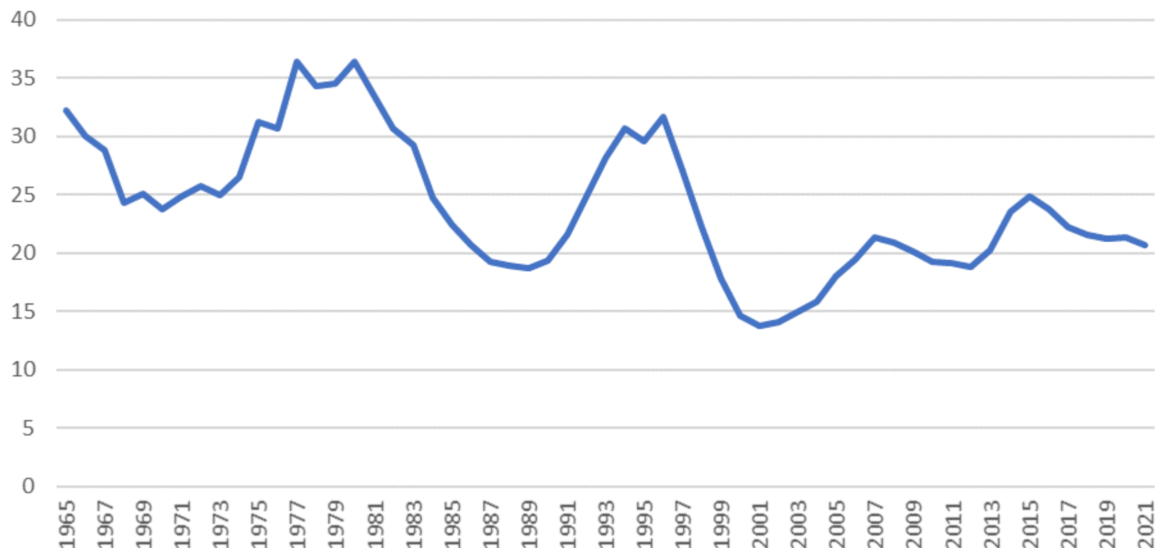
Source: Bloomberg, Antares Equities; March 2023

Implication for Small to Mid Caps (SMIDS)

The other interesting consideration is for the small-mid cap space. The average age of companies in the S&P500 has been declining for the last 40-50 years. Looking at Figure 7, we can't help but wonder whether we are due for some "rebirths" that seem to coincide with market downturns.

For some of the talented tech employees, being laid off from a high paying job at Google or Amazon may turn out to be exactly the impetus they needed to finally launch their innovative passion project or idea that might just be the next big thing (Outside of layoffs, generative AI appears to be the topic du jour in San Francisco). These are the types of companies we look to own when we invest in small caps in the Antares Ex-20 fund – small caps that have the potential to become fast growing, self-sustaining, profitable mid-caps.

Figure 7: Average age of company in S&P500 (years)



Source: Statista, March 2023

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