The Search for Linear Cash Flow Compounders: Enterprise Application Software Stocks on Sale

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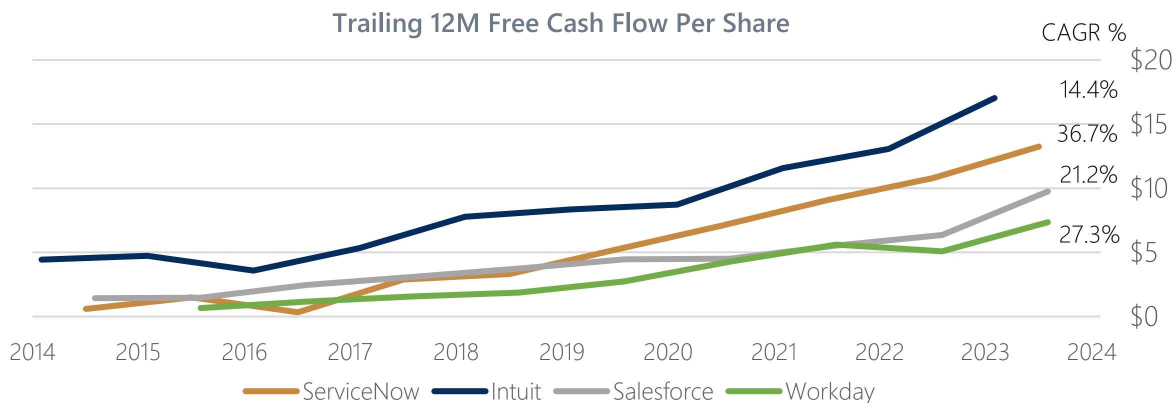
From my very first meeting with SGA in early 2004, I was impressed by the team's unwavering conviction in the philosophy of investing in consistent, reliable, and high cash flow compounders attractively valued on an absolute basis and independently of benchmark considerations. It's a powerfully simple concept and an eminently sensible approach for any long-term investor and client that values absolute wealth preservation and creation.

Despite its simplicity, it can be deceptively difficult to execute because the qualities and virtues that enable the approach to be successful over the long run also ensure there will be periods (sometimes protracted) of relative underperformance when the market pursues more cyclical, speculative or momentum-driven alternatives. Moreover, in periods of extreme index concentration, adherence to an absolute wealth mindset and the attendant rational limitations on position sizes can make a highly disciplined investor appear foolish instead. Nonetheless, the two-decade commitment of the firm to this philosophy - and the absolute wealth of our clients - remains steadfast. We are committed to building portfolios that reliably compound earnings and free cash flows at double-digit rates with lower fundamental variability - and through valuation discipline, continue to seek at least double-digit absolute returns with lower volatility. In the fullness of time, namely the entirety of a market cycle, we expect this approach will continue to generate strong relative results as well given the underlying superior growth profile.

In 2004, the portfolios were filled with traditional consumer packaged goods (CPG) and pharmaceutical companies which had served the portfolios and clients quite well at a predecessor firm as the dot com era unraveled. Looking forward, however, it became increasingly clear that the growth runway for these was tapering and that we would have to expand our pursuit of linear cash flow compounders to other markets and industries. Given my background as an internet entrepreneur and venture capitalist, I naturally gravitated to consumer internet and enterprise software markets.

At that time, enterprise software businesses still delivered software "on premise" which entailed a large upfront (however less predictable) license fee from customers followed by ongoing maintenance streams. The challenge with this legacy model however was that the customer absorbed great cost and implementation risk as each iteration of software had to arduously be physically installed on servers in each office and on the desktop computer of each employee. The advent of software-as-a-service (SAAS) was a paradigm shift in that it allowed business customers to consume vendors' software innovation more easily via the internet. Thus, as SAAS increased innovation adoption cycles while also reducing implementation risk and cost, the business application software market expanded at attractive rates and continues to do so. Moreover, this superior customer value proposition also allowed the vendors to transition to a stronger, far more predictable recurring revenue subscription financial model that is closely aligned with SGA's investment philosophy.



Data as of 6/5/2024. Source: Bloomberg

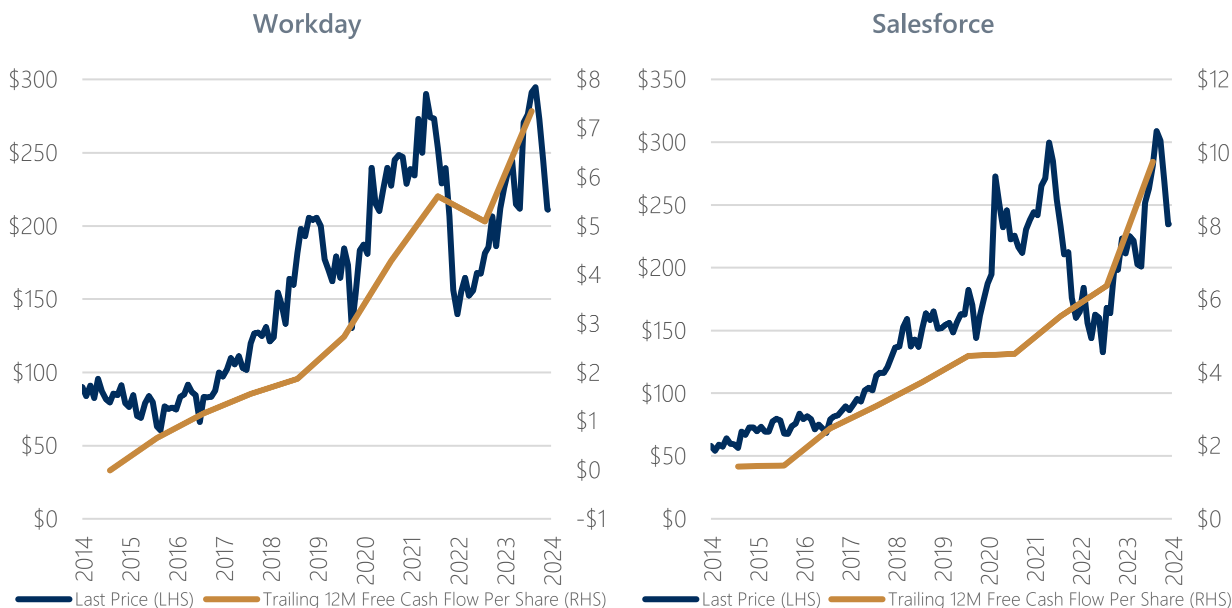
Over the years, we have successfully invested in several software companies that transitioned to the SAAS model as well as newer cloud native ones. Of course, in doing so, we have remained focused on finding market leading companies with pricing power that reliably compound free cash flow (FCF) at attractive rates. The chart above demonstrates how some of

these application software companies have delivered FCF per share compounding at high rates in an almost linear manner over the last decade.

At times, the stock market recognizes the long-term virtues of these models while at others it becomes fixated on short-term disappointments and concerns such as the most recent quarterly performance or exogenous macro considerations causing significant dislocations. In recent weeks, we've seen precisely such an episode. Long-time, free cash flow compounders Workday (WDAY) and Salesforce (CRM) each posted short-term backlog growth that disappointed the market. Backlog growth is an important Key Performance Indicator (KPI) in that it speaks to customer demand and order activity. Short-term backlog growth provides visibility into revenues to be recognized over the next 12 months while long-term backlog growth is indicative of demand beyond the next 12 months.

In the case of Salesforce, we believe that the short-term backlog disappointment was due to the delay of deal closures in EMEA and Latin America as well as a sales organization restructuring in their fiscal first quarter. In the case of Workday, the short-term backlog disappointment was seemingly due to the delay of large deal closures in EMEA as well as lower than expected headcount growth in their customer base. We also suspect that large enterprises around the world are spending time and resources planning for GenAI and building the required technical infrastructure. This in turn may be causing some deferrals of decisions and spending on the application software through which many of the insights created by GenAI will ultimately be deployed into the workflows of organizations.

We continue to focus beyond the current volatility and remain impressed with the track record as well as the future potential of these companies to reliably compound free cash flow per share at attractive rates over the next 3-5 years. In the case of Workday, we continue to expect sustainable top-line growth in the double digits as its natively integrated suite of human resource management and financial management software is adopted in international, government, and medium-sized enterprise markets that have yet to meaningfully transition to SAAS consumption. In the case of Salesforce, we see revenue growth near double digits by helping businesses better manage and integrate their customer interactions - and data - across sales, marketing, ecommerce and service functions as well as a more complicated array of physical and digital channels. See the charts below for the stock price performance [blue] superimposed on the free cash flow per share progression [gold].



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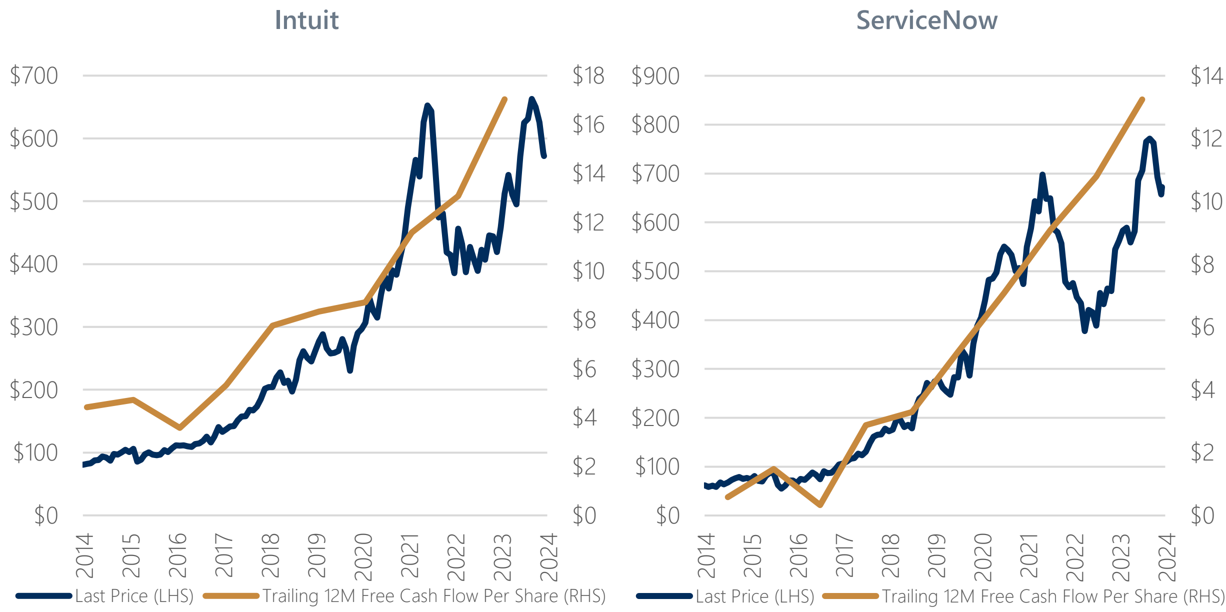

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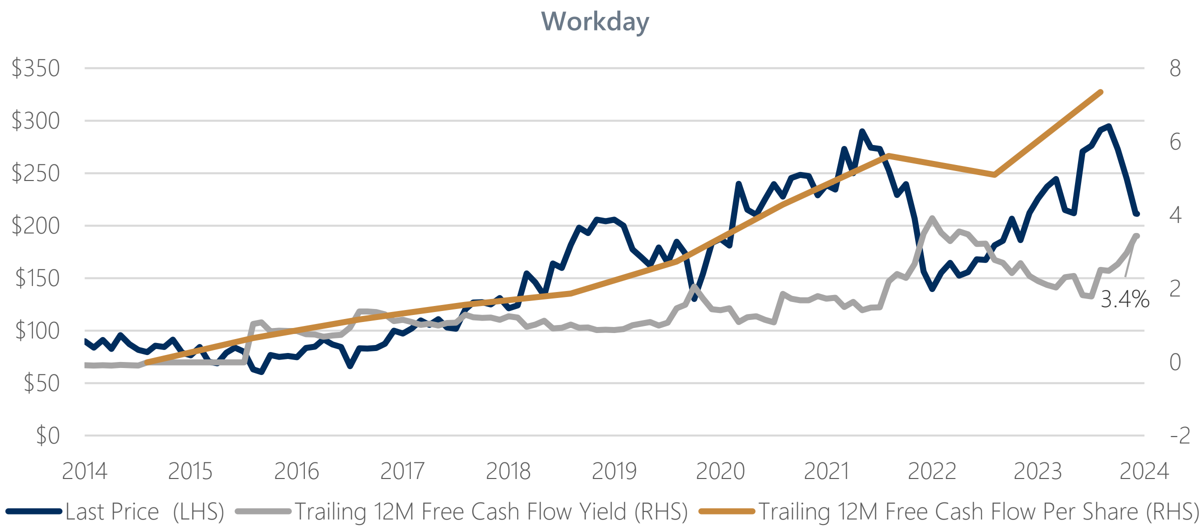
Moreover, we assert that the largest application software companies, which have access to the most customer data, will have the best ability to train GenAI models and produce better insights and workflow automation for their enterprise clients. Said differently, we believe access to client data will increasingly be a new form of scale advantage for the largest incumbents that manifests itself as competitive pricing power and potentially even as an incremental revenue stream. This will admittedly not be material before 2025 at the earliest. Given the emerging - but not yet proven - use cases of these applications, we are not currently modelling for any such incremental benefit from GenAI for the companies discussed here.

We also note that other important KPIs of long-term health remain robust. More specifically, client retention rates persist above 90% - and total backlog growth continues to grow faster than the short-term backlogs. In the case of Workday, we believe this is evidence that the duration of customer contractual commitments has been lengthening. For long-term investors such as ourselves, these are critical and important differentiators in this time of weakness for the stocks.

	Current Backlog			LT Backlog	Retention Rates
	Q1 Management Target	Q1 Actual	Q2 Guidance	Q1 Actual	
WDAY	17.5-18.5%	17.9%	15-16%	24%	95%
CRM (FX-neutral)	~11.8%	~10%	10%	15%	92%

In addition, as these companies continue to demonstrate their pricing power and scale advantages, their margins have risen to the mid-20% range in the case of WDAY and low-30% range in the case of CRM. In both cases, we expect margins will continue to increase steadily over time. The higher the margins, the lower the variability of bottom-line earnings and cash flows. In addition, another source of predictability is rooted in the fact that these "horizontal" software businesses serve companies across a range of industries and thus, are less susceptible to the boom/bust cycles of any one specific vertical industry. The increased FCF stability of these companies has resulted in the initiation of meaningful capital return programs in the last couple of years. The charts below superimpose the trailing free cash flow yield [gray] on the prior FCF/share [gold] and stock price [blue] charts.



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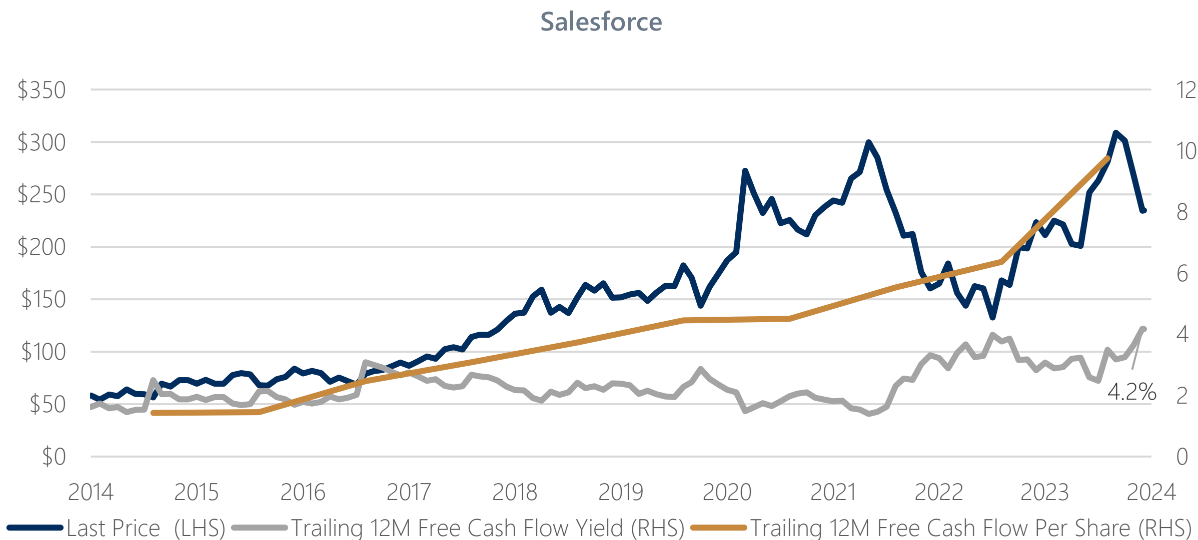

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Conclusion

Despite WDAY and CRM currently experiencing growth rates that seemingly are temporarily depressed, the businesses continue to reliably compound FCF at high rates and more *predictably* than even two years ago during the last broad software equity sell-off. Said differently, they continue to become more aligned with the longstanding SGA investment philosophy of investing in consistent, reliable FCF compounders that resonated with me so strongly when I was first introduced to the firm 20 years ago. Now trading at or near record high FCF yields, the stocks already price in fears and concerns of reduced growth. As such, given our longer time horizon, we view the relative return potential of these reliable free cash flow compounders especially favorably at this time. And, while temporarily out of favor, along with other holdings with high revenue stability, we believe they are well positioned to compound double digit absolute returns in the years to come.

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