ClearBridge Investments

Enterprise Software Offers Differentiated Growth Through Market Cycle

October 28, 2021

Key Takeaways

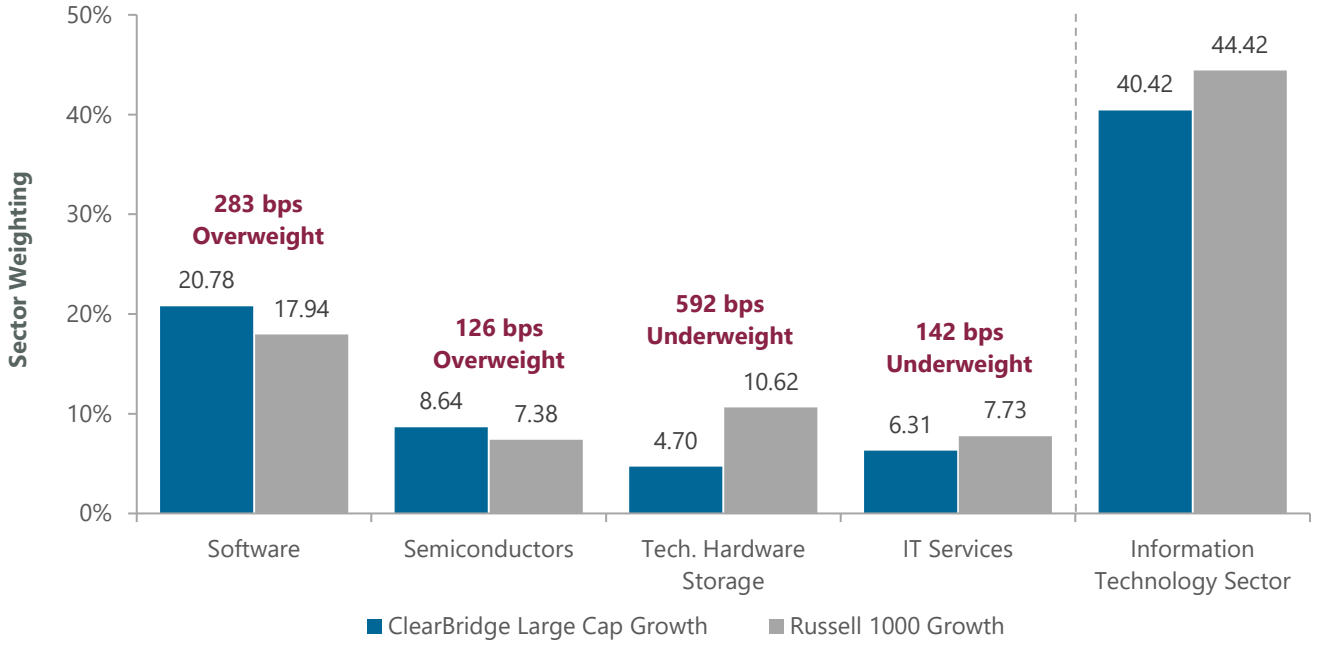
- Recent positioning moves have better targeted our focus on software-as-a-service (SaaS) companies with the most compelling risk/reward profiles in the areas of cybersecurity, IT collaboration and enterprise resource management.
- With digital transformation accelerating across industries, we expect enterprise software makers, as the key enablers of that transformation, are positioned to deliver some of the best revenue and earnings growth going forward.
- We believe that owning a broader group of software companies with different drivers to the businesses helps manage some of the risk in this relatively more expensive subsector.

Cloud-Based Subscription Model in Early Days of Adoption

Over the last several quarters, we have sought to improve the up capture of the Large Cap Growth Strategy by expanding exposure to the select bucket of growth companies growing revenues and earnings at meaningfully above-average rates and targeting large total addressable markets. Enterprise software makers serving a wide array of clients are a good example of select growers as they have the potential to deliver consistent growth regardless of the economic backdrop. We are attracted to the recurring revenue nature of these companies that are increasingly delivering their products on a subscription basis through the cloud. Software business models also tend to avoid many of the inflationary issues facing companies with a physical product or service.

As an active growth manager, we can take a high-conviction approach in enterprise software. At the end of the third quarter, enterprise software names accounted for four of the portfolio's top 11 positions, a more focused exposure than available through passive vehicles indexed to the benchmark Russell 1000 Growth Index. We have chosen to overweight software versus the benchmark as we see better risk/reward in this area than in more legacy information technology (IT) subsectors like devices (Exhibit 1). The attractive growth characteristics of SaaS were already well understood prior to the COVID-19 pandemic, but the move to remote work lit a fire under cloud delivery and solidified customer adoption plans. While traditional industries were struggling with shutdowns, software fundamentals held up fairly strongly and have since maintained their positive momentum.

Exhibit 1: Expressing High Conviction in Software



Data as of Sept. 30, 2021. Source: FactSet.

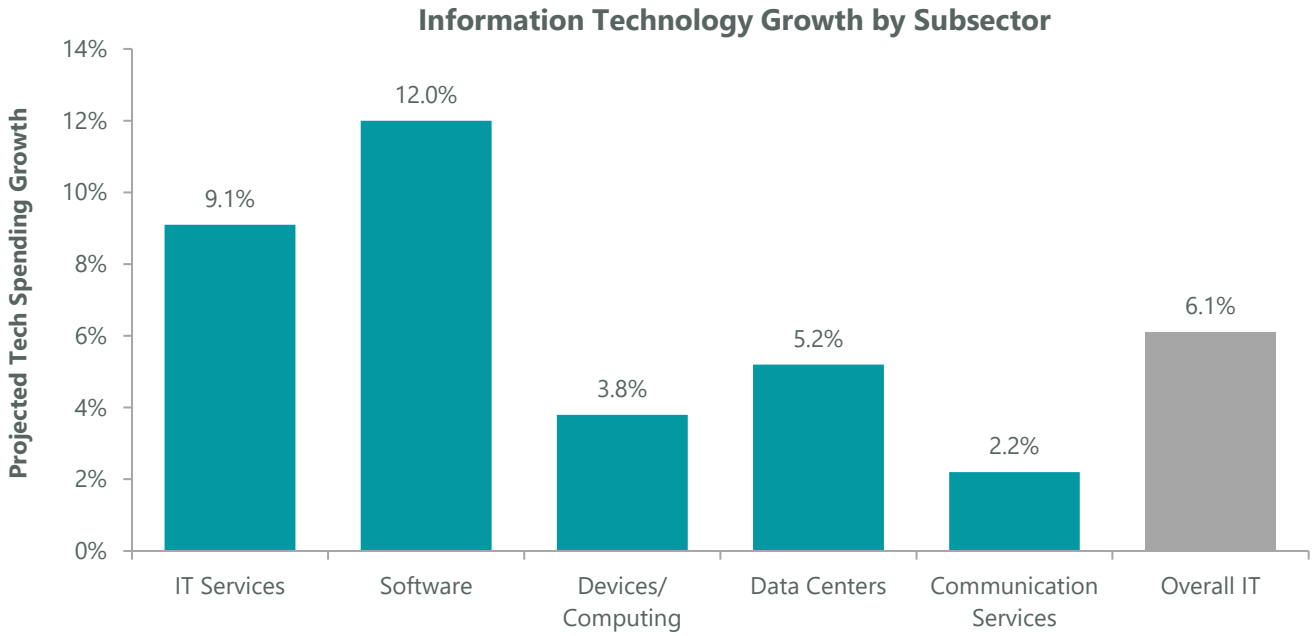
Newer enterprise software names like Atlassian and existing holdings such as Palo Alto Networks have been strong contributors to relative performance over this period. We believe that owning a broader group of software companies with different drivers to the businesses helps manage some of the risk in this relatively more expensive subsector. One area of software receiving significant attention is collaboration. This is where companies like Atlassian, an Australian-based maker of software for application development, IT operations, and collaboration solutions, can make a difference. Atlassian has delivered strong results since our initial purchase in the fourth quarter of last year as the company's cloud business accelerated, customer demand across the company's product suite broadened, and the business added a record number of new customers. Atlassian has also demonstrated accelerating subscription revenue growth while maintaining its best-in-class operating margin profile.

Palo Alto Networks is a provider of enterprise security solutions, including next-generation firewalls and threat detection software. Given expansion of remote work during the pandemic adding new complications to securing enterprise networks and increasingly complex threats posed by hackers, security has become an even further heightened IT investment imperative, especially cloud security because that's where a lot of workloads are migrating. Palo Alto Networks is seeing strength in both its core firewall business as well as next generation security solutions, with billings and revenues topping forecasts in the most recent quarter and the company raising its long-term guidance. Splunk also plays a critical role in cybersecurity as its data aggregation, monitoring and analysis solutions are frequently used in conjunction with other security vendors.

Software that enables the digital transformation of front office applications like Adobe's marketing automation offerings were already in high demand prior to the pandemic. More recently, we have seen transformation extend into different areas including back-office applications. Recent portfolio addition Workday maintains a leadership position in an $88 billion market for human capital management solutions while its financials solutions have begun to accelerate, fueling a second growth vertical for the company. We like how Workday has developed multiple landing points with customers which could lead to a significantly expanded potential market and the ability to win larger contracts going forward.

Since we cannot own all of the large cap software companies in our benchmark and still maintain a diversified portfolio, we consider business exposures in some of our underweight positions. For example, the portfolio's underweight to Microsoft is less pronounced when you consider how we participate in one of its primary revenue drivers, corporate technology spending, through ownership of enterprise software companies like Salesforce.com. With a new CFO focused on delivering consistent growth and expanding margins, Salesforce could soon surpass SAP as the world's largest enterprise applications provider with an all-subscription-based model. The recent acquisition of Slack should better connect the company's products and services with its users as the messaging platform becomes more dynamic and interactive.

Exhibit 2: Software is Fastest Growing Area of Technology Spending



As of Sept. 2021. Source: Gartner. Projected end user spending from 2019-2025 on a compounded annual growth rate basis.

We believe that digital transformation and rising demand for software is a secular growth trend that should only accelerate from here. At this point, software still accounts for just 15% of IT budgets but we expect that number will grow as cloud adoption plans pick up. In fact, Microsoft CEO Satya Nadella estimates that technology will grow as a percent of GDP from five percent today to 10% over the next 10 years with much of that being software spending. We also find the recurring revenue nature of subscription-based software businesses compelling for both customers, who can purchase products more flexibly and rapidly, and companies that can invest through cycles with support from a consistent revenue stream.

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