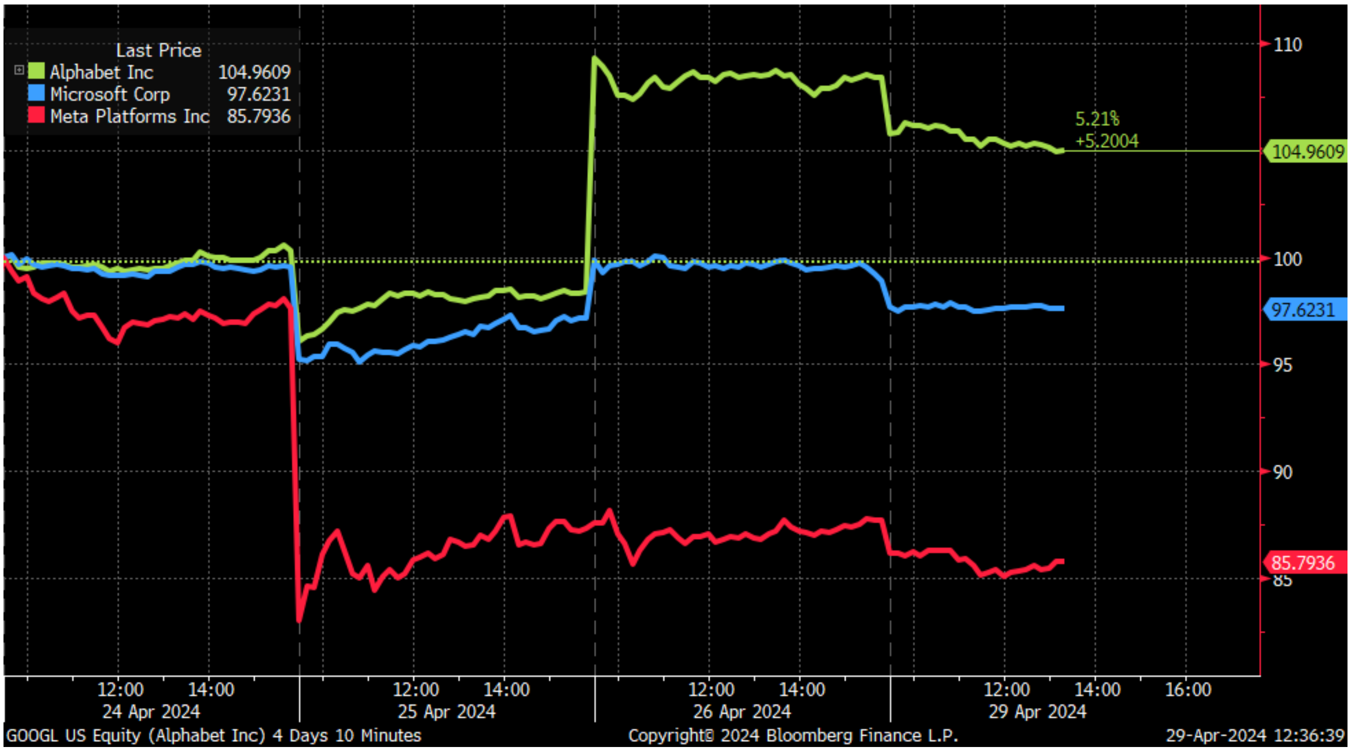
Big Tech, Big Earnings, Big Spending

Last week, Microsoft, Alphabet and Meta reported their quarterly earnings and provided guidance updates. The consistent theme was increasing investment in computing infrastructure to support future growth opportunities – particularly in artificial intelligence. Despite similar themes from management, the market reaction to these updates was anything but consistent. While shares of Microsoft and Alphabet rose post-announcement, Meta's stock suffered a sharp drop and is currently 15% lower than its pre-earnings price.[1]



For Microsoft and Alphabet, much of the investor focus was on their cloud computing results, which exceeded consensus estimates. Along with Amazon (which reports its quarterly results Wednesday), Microsoft and Alphabet dominate the $663 billion global market for cloud computing services (expected to double to $1.3 trillion by 2028).[2] The firms' latest trailing 12-month financial highlights are shown in the table below, along with their cloud revenue and spending on investments (both capital expenditures and research and development).

(Dollars in Millions)

Company	Market Cap	T12M Revenue	T12M Net Income	T12M Cloud Revenue	T12M R&D Expense	T12M CapEx	2024 PE Ratio	ROIC (%)
Microsoft	2,983,710.31	236,584.00	86,219.71	100,840.00	28,193.00	39,547.00	34.02	32.90
Growth YoY(%)		*17.03*	*36.44*	*14.71*	*3.25*	*51.90*		
Alphabet	2,088,235.12	318,146.00	83,593.37	35,208.00	45,862.00	37,974.00	23.34	31.37
Growth YoY(%)		*15.41*	*26.28*	*26.13*	*9.59*	*35.68*		
Meta	1,097,182.62	142,711.00	50,760.86		39,080.00	26,824.00	20.58	35.08
Growth YoY(%)		*27.26*	*35.57*		*8.67*	*-18.37*		
Amazon	1,875,027.24	574,785.00	30,699.92	90,757.00	85,622.00	52,729.00	34.75	12.30
Growth YoY(%)		*11.83*	*5.34*	*13.31*	*16.95*	*-17.15*		

Source: Bloomberg (4.29.24)

600 Central Ave, Suite 365
Highland Park, IL 60035
(847) 559-9700
www.fortllc.com

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While all four companies are making investments in cloud infrastructure (e.g., data centers, semiconductors, networking equipment) as well as artificial intelligence models, we think the variance in market reactions comes down to the near-term monetization of this spending. Whereas Microsoft, Alphabet and Amazon have established cloud businesses, the payoff from Meta's capital expenditures (which it expects will rise to $40 billion in 2024) is more distant and questionable.

We think investors bailing on Meta are at risk of making the same mistake as 18 months ago, when the shares suffered a nearly 70% drop from peak-to-trough over investor anxiety regarding the increase in Meta's spending. When Microsoft or Alphabet open new data centers or make advances in their artificial intelligence models, they can sell their computing capacity or AI capabilities to cloud customers. Meta on the other hand benefits in a more discreet way by improving the content and ad quality that its users see. This ultimately keeps its users engaged and advertisers willing to spend – driving higher revenue. At the end of the day, revenue derived from selling more products to external customers vs revenue from improving core services is still revenue.

Additionally, we think investors also may be concerned about the portion of Meta's continued investments related to its Oculus VR platform and the "metaverse." We are more sympathetic to these concerns but think Mark Zuckerberg has earned the benefit of the doubt by now. The ramp-up in spending two years ago was in large part attributable to the firm buying tens of thousands of Nvidia's most advanced GPU chips during a brief period they were selling for discounted pricing (just prior to the rollout of ChatGPT and the beginning of the AI gold rush). This proved adept and enabled Meta to improve its Instagram Reels product and accelerate the development of its LlaMa AI model. While we are admittedly unsure about the future of virtual reality and spatial computing, Meta has a history of executing on growth opportunities (recall its much panned at the time purchase of Instagram in 2012 for $1 billion, for instance). If the company fails at building this new computing paradigm, its core services won't be any worse for it – but if it succeeds, the payoff could be immense. For now, the option value of potential success is not reflected in the share price.

We look forward to following Amazon's results on Wednesday. Given the solid cloud computing results from Microsoft and Alphabet, we expect similar trends at Amazon. While cost efficiency measures in its retail business along with the firm's growing advertising sales should lead to improved ecommerce profitability. We remain constructive on owning all four firms and would be buyers on any meaningful selloffs – whether that is due to volatility around quarterly results or pressure from rising interest rates.

Please let us know if interested in discussing your current holding in these positions, or whether it makes sense to consider adding them to your portfolio.

Sincerely,

Peter Karmin	Stuart Loren
Managing Member	Director

Citations and Disclosures

[1] Bloomberg (as of 4.29.24). All financial data cited herein is from Bloomberg unless otherwise noted.
[2] Bloomberg Intelligence, Generative AI 2024 (March 28, 2024).

FORT SHERIDAN
ADVISORS

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