

Why we're buying software today

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Bottom line up front:

The software sector has experienced a dramatic shift in market perception over the past decade, moving from high valuation optimism to concerns about AI's impact and profitability. This change has created new opportunities for value investors.

For most of the last decade, the market has viewed the software sector through rose-colored glasses. The prevailing narrative was that the SaaS business model (Software-as-a-Service) was one of the best in the world, characterized by recurring revenue, ample growth opportunity, high margin potential, and fundamental protection from inherently high switching costs.

At Harris | Oakmark, we have long admired software businesses for these characteristics. Revenue retention, pricing power, and room for growth are qualities we seek out as long-term business owners. However, over the last decade, we have often struggled to reconcile market valuations with actual business results, especially when those valuations were based on adjusted earnings metrics that ignored the very real cost of stock-based compensation. We've also questioned the durability of growth rates that the market seemed to extrapolate into perpetuity, wary that competitive forces would eventually temper even the most exciting trajectories. For these reasons, with a few isolated exceptions, we have been underweight the software sector for the last decade.

In the last year, though, the market's narrative on the software sector has completely reversed. Now, it appears the market is convinced that generative AI poses an existential threat to the industry. If the cost of code approaches zero, the thinking goes, the moats around existing software businesses will evaporate. Furthermore, if large language models (LLMs) fundamentally change how knowledge workers interact with applications, the differentiation enjoyed by incumbents could erode. These are valid questions that have made the future trajectories of these businesses seem far less certain. This uncertainty has forced a reckoning: a market that once happily ignored costs in the pursuit of growth is now demanding the safety of GAAP earnings – a standard against which many software companies fall woefully short. As a result, valuations for the industry have collapsed.

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As value investors, we navigate the area between these two extremes. While we share today's concerns regarding the lack of GAAP profitability for the sector at large, we believe the truth about business quality lies somewhere in between these narratives. In our view, the current fear that AI will displace software incumbents fails to appreciate how large enterprises actually operate.

The first bear case assumes that because AI lowers the barrier to writing code, companies will simply build their own custom solutions, effectively "vibe-coding" bespoke customer relationship management (CRM) or enterprise resource planning (ERP) systems. We believe this fundamentally misunderstands the role of enterprise-scale software. C-suite executives of the largest, most complex businesses in the world do not choose software suites like Salesforce or SAP because they have the slickest user interfaces or the coolest new features. Executives choose established players because they are industry-standard products that offer a level of reliability, support infrastructure, and an ecosystem that cannot be matched by startups or in-house, custom-built solutions.

Regarding the second bear case, which revolves around a changing landscape for how knowledge workers interact with software, we sympathize with the general premise. We suspect that, over time, clever entrepreneurs will find countless ways to use LLMs to revolutionize how employees execute their daily tasks. However, where we differ from the consensus is that we believe this evolution may ultimately increase the value added by established software leaders.

The utility of any AI tool is ultimately limited by the depth and quality of the data it can access and manipulate. We believe incumbent enterprise software companies have a distinct advantage here, serving as both the core systems of record and the mechanism by which work actually gets done. These systems sit on vast reservoirs of proprietary data – including sales pipelines, customer information, and financial transactions – all housed in secure environments. We believe that as AI becomes a critical component of the modern enterprise, it will rely heavily on the structured, trusted data and workflows that are encoded within these core systems. Rather than displacing these applications, the rise of AI may actually deepen enterprises' reliance on them, making incumbent software systems even more essential than they are today.

While we acknowledge the potential for change in the industry, we believe the market's indiscriminate sell-off has created a rare opportunity to acquire excellent businesses at compelling prices. As value investors, we are willing to embrace uncertainty, provided that the current price adequately compensates us for that risk. We believe mission-critical software suites that are deeply integrated across their clients' workflows are unlikely to be displaced, and may even become more valuable in a world where generative AI plays a central role in the enterprise. Now that we are finding companies that meet our quality criteria at attractive valuations, we are selectively increasing our exposure to the sector.

Jeremy G. Thames, CFA

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