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Short Snowflake (NYSE: SNOW) before its earnings release (ER) today (May 25 2022, after close), use a modest size

- Share price likely to decline sharply further, due to high valuation, slowing growth, and negative macro environment

Our trade

- Long June 10 130/110 put spread, targeting a minimum 20% decline from current price around $130

Situation

New IPO, highly volatile, attractive segment, rapid growth, solid financials, extreme valuation, sign of a slowdown

- IPO at $120 in Sept 2020, share price briefly traded above $400 before declining 67% to current level around $130
- Selling analytics software (AS) and providing cloud data warehouse (CDW) services to enterprises
- FY22 (end Jan 30 2021) revenue (REV) $1.2 bn (up 106% YOY), backlog $2.6 bn (up 98% YOY), gross margin (GM) 74%
- Credible mgmt., solid balance sheet ($5.1 bn cash and $205 mm debt), cash flow positive, but not profitable yet
- Market cap of $43 bn, at a price-to-sales ratio of 36, forward price to earnings over 1000, and PEG above 5
- FY20, 21, 22, 23 REV growth and GM are (164%, 120%, 106%, 66%) and (62.8%, 68.7%, 74.1%, 74.5%) respectively

Analysis

Growth to slow, fierce competition, negative environment to get worse, valuation needs to further normalize

- Slowdown inevitable after explosive growth during the pandemic, and amid recent market turmoil
    - Sector growth still healthy but moderated, as seen in recent AMZN, MSFT, GOOGL ERs before market turmoil
    - SNOW relied on B2C businesses - financial, retail, advertising, health care, and tech accounts for 85% of REV
    - In Q4 FY22 call, mgmt. noted REV headwind but attributed it to software upgrade and new pricing model
    - FY23 growth guided lower, distress in core verticals, and recent SNAP negative update all indicate a slowdown
- Competition fierce and likely to intensify, SNOW's growth profile cannot justify an excessive valuation premium
    - SNOW bundles its analytic software (AS) with CDW offerings from AMZN, MSFT, and GOOGLE to sell to its clients
    - AMZN, MSFT, GOOGL bundle their own AS and CDW, compete directly with SNOW
    - Players swiftly copy each other, making their offerings difficult to distinguish, it is a constant arms race
    - SNOW has to compete with dominant players (AMZN, MSFT, GOOGL) with much larger R&D budget and staff, with legacy players (IBM, ORCL, etc.) beefing up their cloud offerings, and with new entrants (DDOG, HPE, etc.)
    - At REV of $1.2 bn, SNOW is very small compared to the cloud businesses of the dominant players but traded at a huge premium. However, competition quickly drives its growth toward sector mean (roughly 40-50% in 2021)
    - As pandemic recedes and growth further slows, competition likely to intensify, given the enormous investment in the space with numerous players of little differentiation competing for a smaller pie
- Macro environment took a turn for the worse
    - NASDAQ 100 and S&P 500 dropped roughly 30% and 20% amid high inflation, rate hike and QT, war, lockdown
    - Fed hiked rate twice, 75 bps total, far away from the 300 bps expected, and has not even begun QT
    - Early signs of severe economic slowdown are everywhere, and inflation remains high with April CPI at 8.3%
        a. New home sales down 16.6% in April after a 10.5% decline in March, 30-year mortgage rate at 5.5%
        b. Retailer inventory to sales at 30-40% (WMT, TGT, HD, KSS, etc.), a ratio normally ranging at +/-10%
        c. Firms began hiring freeze or firing (FB, NFLX, etc.), and guided earnings drastically lower (SNAP, ANF, etc.)
    - Pressure mounting on Fed. Some market commentators and noted investors call for "shock and awe" tightening to defeat inflation
    - No alternatives for the Fed other than to follow through its own plan of rate hikes and QT at the minimum, against backdrop of a rapidly decelerating economy, elevating risks of a recession in 2023 or sooner
    - Macro uncertainties will suppress demand and thus the growth of SNOW, regardless if there is a recession
- Despite the sharp decline in share price, market outlook and SNOW fundamentals cannot justify its current valuation

Conclusion

- SNOW share price likely to decline significantly more near term, even if ER meets or marginally beats expectations

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