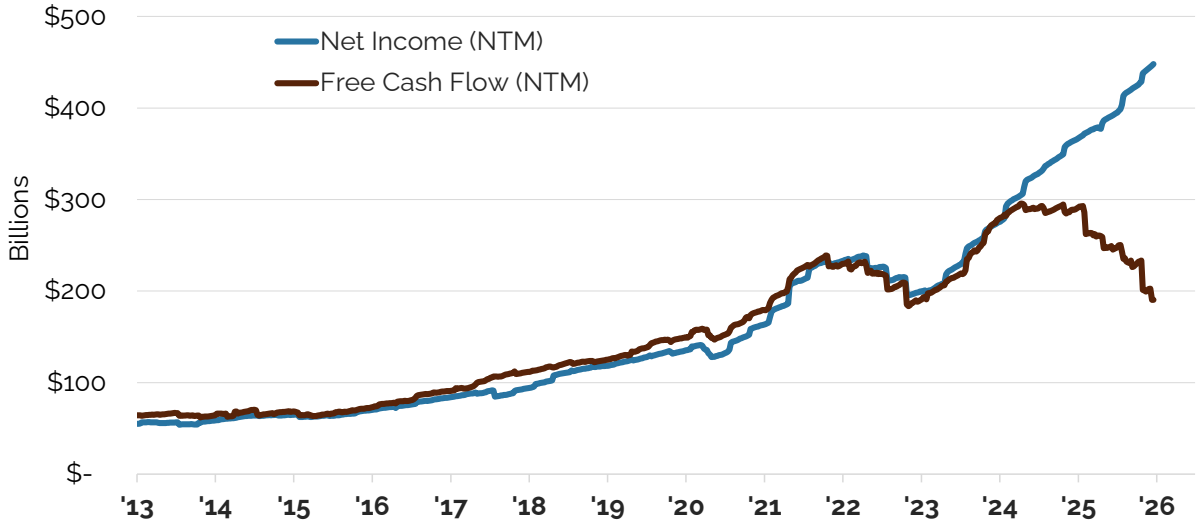
DISTILLATE CAPITAL

How Profitable Are Big Tech Companies Really?

Why the debate about the depreciable lives of GPUs misses the bigger issue of accounting vs. cash profits

The AI race has led the hyperscalers (Microsoft, Amazon, Alphabet, Meta, and Oracle) to spend around $1.1 trillion on capital expenditures and research and development (R&D) in just 2024 and 2025. While the capital committed is real, much of the impact on net income has been muted by long established GAAP accounting rules, which we think is being misunderstood by many market participants and in the recent debate over the depreciable lives of expensive graphics processing unit (GPU) chips. Accounting profit (net income) and free cash flow that were previously closely linked have consequently diverged sharply as is evident in **Figure 1** below.

Figure 1: Hyperscaler* Net Income vs. Free Cash Flow



Source: FactSet, analyst consensus next twelve month (NTM) estimates as of Dec '25

Why has it broken down?

The divergence in accounting profits and free cash flow results from the fact that net income does not reflect actual outlays on capital expenditures when they are incurred but free cash flow does. The accounting rules that relate to net income demand that companies' smooth certain capital expenditures over time through a charge called depreciation and amortization (D&A). The logic behind this accounting convention is that if a company invests in a new plant or equipment only occasionally, it makes sense to smooth out that capital outlay over its useful life. This way, net income is reduced by only a portion of the purchase price each year instead of fully hitting income in one year with no impact subsequently. For example, if a new auto plant was built in one year and lasts for 20, net income would be reduced by 5% of the purchase price each year for 20 years. The use of D&A to smooth the plant cost in this situation allows net income to more accurately reflect true ongoing profitability so that investors can better assess the financial performance of that company. Earnings Per Share (EPS), which is derived from net income is then used in the Price-to-Earnings (PE) calculation, which has long been the preferred financial measure of valuation on Wall Street.

Research and development (R&D) spending is treated differently than capital expenditures (Capex) even though both are investments designed to generate future profits. Capex is typically an investment in tangible assets that get capitalized on the company's balance sheet and then expensed over the life of the asset through D&A. R&D, by contrast, typically involves spending on intangibles like patents or intellectual property and does not get capitalized on a balance sheet. Unlike capital expenditures, it is expensed fully as incurred rather than slowly over time through depreciation charges. So, any spending that is booked as R&D impacts both accounting profits (net income) and free cash flow completely in the year it is spent and not gradually over time as is done with capital expenditures. In our foundational

***For the purposes of this paper, "hyperscalers" refers to Microsoft, Amazon, Meta, Google and Oracle.**

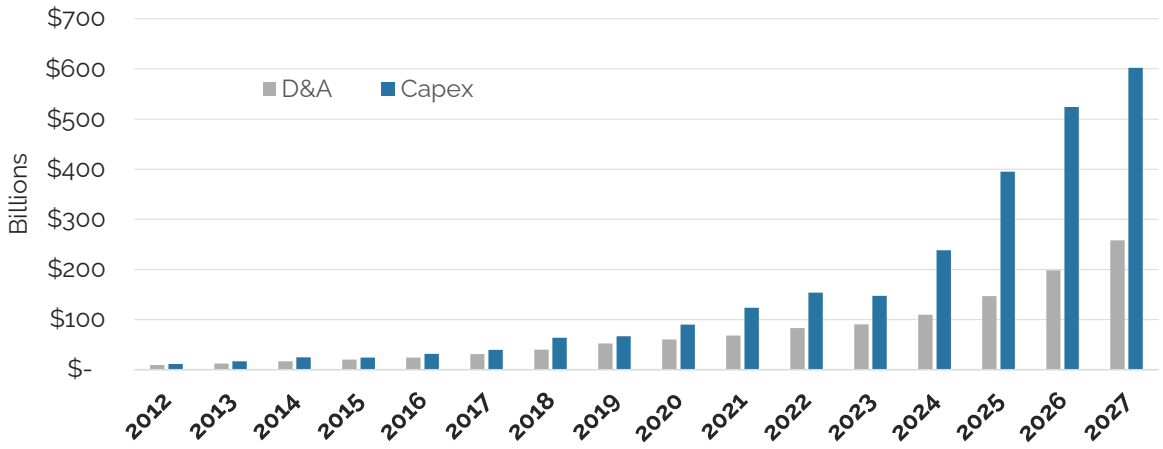
paper titled "Value Investing in a Capital Light World", we explain this difference in more detail and its impact on traditional cross-sectional valuation measures the financial community has so long relied upon. These differing accounting treatments of R&D and capex are also the reason that when we consider valuation, we utilize free cash flow (FCF), which counts all expenses when they are incurred (capex and R&D), as a better "real time" barometer of true profitability.

While the hyperscalers are investing substantially in both R&D and capex, it is the massive increase in the latter that is causing free cash flow and net income to diverge sharply at the moment. The following analysis of the hyperscalers will hopefully provide a useful example of why.

Why this matters today?

For the hyperscalers at present, the dramatic expansion in capital expenditures has not been a one-off event like in the auto example, but a sustained surge over several years that management teams have signaled will likely continue. Consequently, if capital expenditures for the group continues to grow as is forecast, or even if they level off at current levels, D&A charges that smooth out capital expenditures on a backward-looking basis are currently significantly understating these companies' true costs and are potentially misleading investors as to the ultimate underlying profitability of the ventures they are undertaking. While D&A and capital expenditures were closely linked for these companies previously, with D&A averaging around 80% of capex historically, this figure is now below 40%. The growing gap between capex and D&A is evident in **Figure 2** and explains the recent significant chasm between net income and free cash flow seen in **Figure 1**. The absolute difference between these numbers is estimated to be $300 billion in 2026, hardly an inconsequential figure. For context, that is equivalent to around 70% of the consensus-projected net income for the entire group in 2026. For an investor examining financial performance and valuation, this is of enormous consequence.

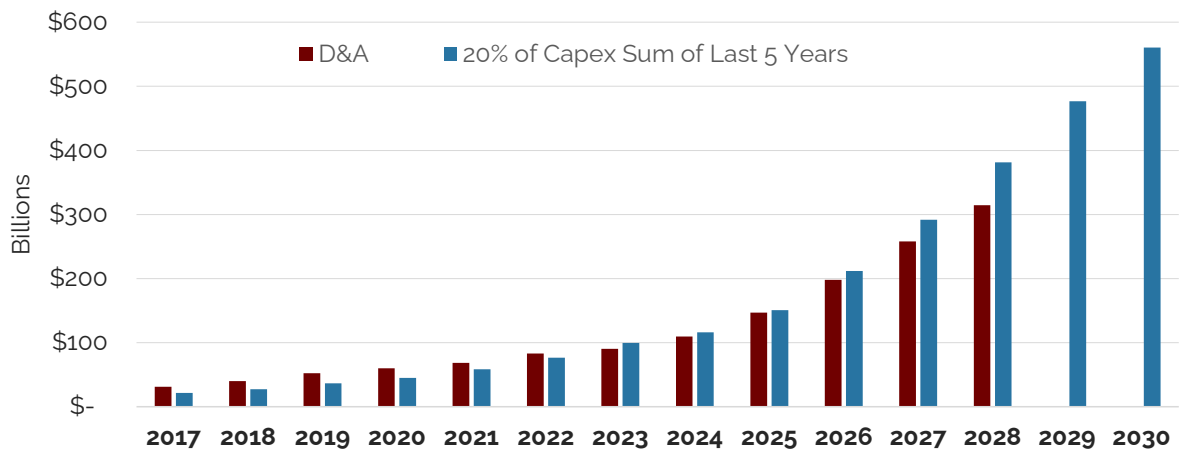
Figure 2: Hyperscaler Combined Capital Expenditures vs. Depreciation



* Microsoft, Amazon, Alphabet, Meta, Oracle Source: FactSet; data as of 12/24/2025

Historically, D&A for the hyperscalers has averaged around 20% of the sum of total capital spending over the prior 5 years. If consensus figures for capital expenditures for this group are used through 2029 (when they are forecast to reach over $650 billion) and are kept flat in 2030 (when there are not reliable estimates), D&A charges are likely to grow steadily over time to near the current level of actual capital expenditures (See **Figure 3**). In essence, what the figures show is that D&A is massively lagging current capex spending and flattering reported net income relative to free cash flows, but what only a few analysts are talking about is that D&A will soon catch up and exert enormous pressure on net income in the coming years as it does.

Figure 3: Hyperscaler Combined Depreciation & Amortization vs. 20% of Summed Capex Over Trailing 5 Years

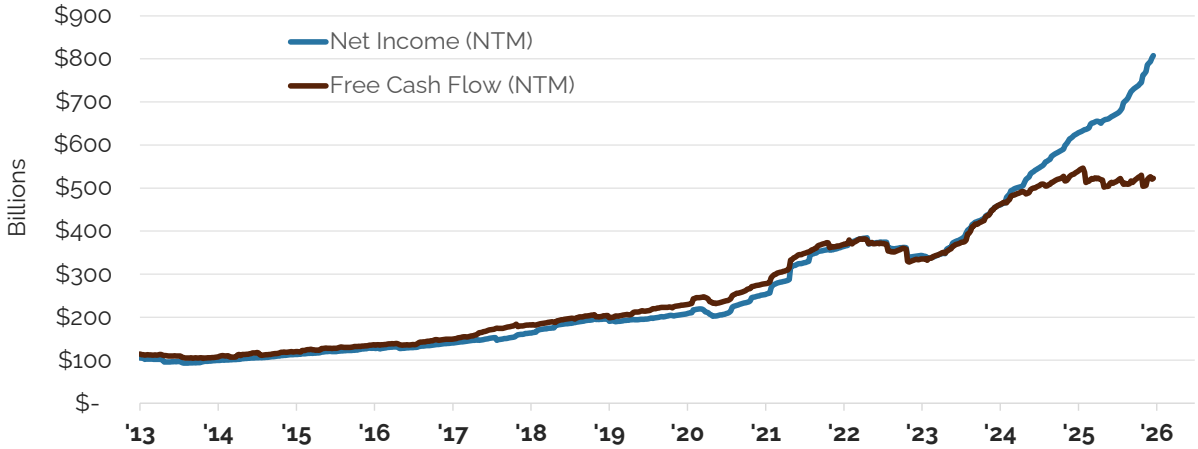


* Microsoft, Amazon, Alphabet, Meta, Oracle Source: FactSet; data as of 12/24/2025

Enter the beneficiaries of the hyperscaler spending

It is also important to realize that none of this spending is happening in a vacuum. While the capital expenditures from the hyperscalers are not being fully reflected in their own net income, their spending is generating substantial profits both in terms of net income and free cash flows for other companies. NVIDIA has been the main beneficiary as much of this spend has been on the GPUs that it makes. Because of this, it makes sense to look at the profitability of the larger group including these beneficiaries. This is done in **Figure 4** which adds the remaining Mag-7 stocks (NVIDIA, Apple, and Tesla) along with Broadcom to create a group of stocks that we have previously referred to as the "Big 9." At the time of this writing, this group makes up around 40% of the S&P 500 by weight. Figure 4 shows that like the hyperscalers, net income and free cash flow for this group tracked closely before sharply diverging in early 2024. While income growth is obvious, free cash flow for the larger group has essentially flatlined as the spend from the hyperscalers has gone into the pockets of NVDA and AVGO (and others) but has not generated incremental free cash flow for the group as a whole. The huge rise in net income results from the fact that it counts the profits to NVDA and AVGO from the hyperscalers' spending while largely ignoring the negative impact from this investment on the hyperscalers own income statements because of the lag in D&A.

Figure 4: Big 9* Net Income vs. Free Cash Flow



Source: FactSet, analyst consensus next twelve month (NTM) estimates as of Dec '25. Hyperscalers (MSFT, AMZN, META, GOOGL, ORCL) Plus Four (AAPL, NVDA, TSLA, AVGO).

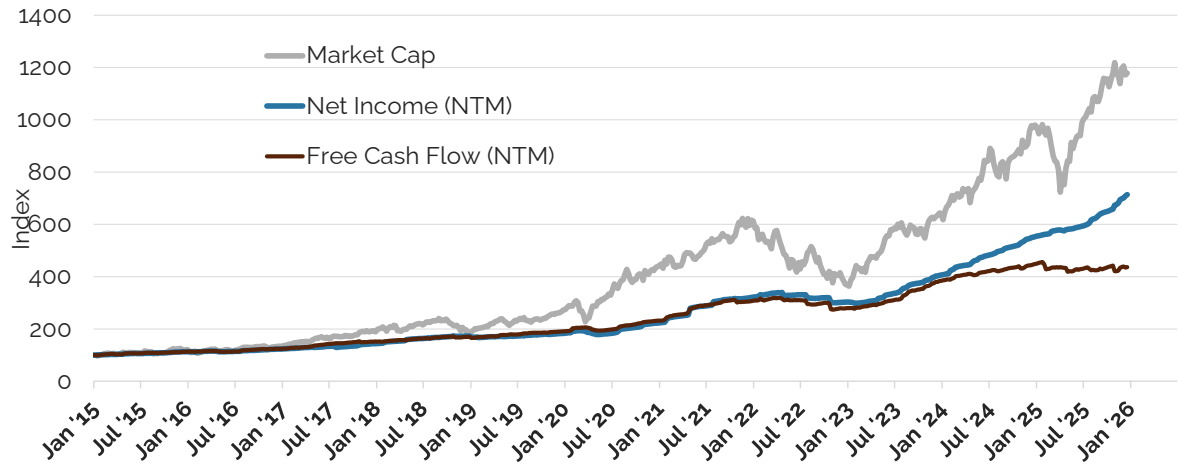
***For the purposes of this paper, "Big 9" refers to Microsoft, Amazon, Meta, Google, Oracle, Apple, Nvidia, Tesla and Broadcom**

In some sense the GAAP accounting treatment for the whole group is all the fun without any of the pain. It counts the hyperscalers spending as a positive contributor for NVDA and AVGO but not as a negative for the hyperscalers themselves. Put even more simply, GAAP accounting and lagging D&A expenses are making this group of stocks look like it is generating around $300 billion more in profits than is actually the case unless meaningful new revenues and profits materialize to offset the massive rise in capital expenditures. Thinking about this group as a whole is also instructive in that if the hyperscalers suddenly reduced AI spending, it would benefit their own free cash flows, but sharply reduce free cash flows for NVIDIA and Broadcom such that overall free cash flow for the group may not shift that much. Net income in such a scenario, however, would likely fall sharply for the group as it would decline significantly at NVIDIA and Broadcom while remaining largely unchanged for the hyperscalers.

How does this impact valuations?

Finally, it is crucial to look at valuation in the context of these different measures of profitability. To begin with, free cash flow growth has been substantial for the Big 9 and has quadrupled since 2015. Due to the benefit of lagging D&A versus capital expenditures, net income is sharply higher at nearly a 7x increase over the same period. Price, or the summed market caps of these companies, however, is up substantially more at nearly 12x. So since 2015, while free cash flow has risen an impressive 4x and net income has grown even more due to the issue of D&A accounting, prices are up three times as much as free cash flow. This is evident in **Figure 5** below.

Figure 5: Big 9* Indexed Market Cap, Net Income & Free Cash Flow

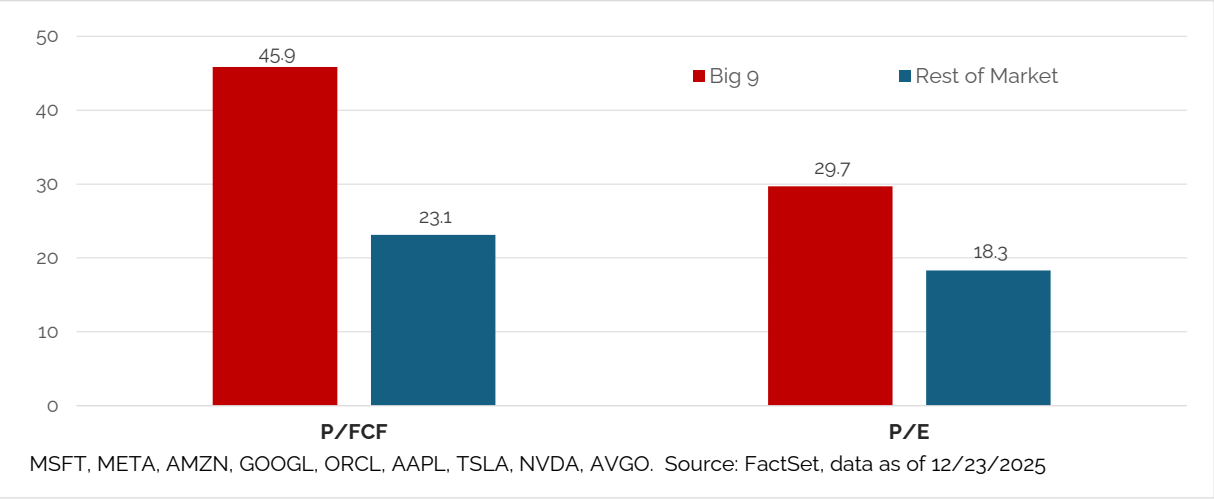


Source: FactSet, analyst consensus next twelve month (NTM) estimates as of Dec '25. Hyperscalers (MSFT, AMZN, META, GOOGL, ORCL) Plus Four (AAPL, NVDA, TSLA, AVGO).

The enormous increase in price over free cash flow is resulting in very rich valuations for the group today, which is shown in **Figure 6** on the next page on both a P/E and P/FCF basis, with the valuation for the rest of the market also shown for comparison. While the group is 50% more expensive than the rest of the market on a net income basis, for the reasons detailed earlier, we do not think this is the most accurate valuation measure. On the basis of free cash flow, which we think more accurately reflects underlying profitability, the Big 9 group that comprises around 40% of the S&P 500 is trading at roughly twice the multiple of the remaining 60%. This valuation is even more extreme when considering that free cash flow growth for this group has largely been flat over the past several years.

***For the purposes of this paper, "Big 9" refers to Microsoft, Amazon, Meta, Google, Oracle, Apple, Nvidia, Tesla and Broadcom**

Figure 6: Price to Income (NTM) and Free Cash Flow for the Big 9* vs. the Rest of the S&P 500



MSFT, META, AMZN, GOOGL, ORCL, AAPL, TSLA, NVDA, AVGO. Source: FactSet, data as of 12/23/2025

Conclusion

While this analysis hopefully sheds light on the massive disconnect between accounting profits and cash profits, there are several important additional points to note. First, the free cash flow figures for these charts are based on consensus expectations and so do not include the impact from the dilution from equity option issuance which is substantial for a number of these companies. Second, while the hyperscaler analysis was broadened to the Big 9 in an attempt to wholistically show the impact on profitability for both the spenders and receivers of that spend, it does not contemplate the issues of profitability and the enormous cash losses at many of the AI companies like OpenAI that are some of the major customers of the hyperscalers. This is an additional significant risk if these companies end up being less profitable than is hoped for and cannot indefinitely access external funding for the enormous and growing losses associated with training and running their models.

Beyond these notes, the overall story is that while the impact of D&A on hyperscaler profitability has garnered recent attention with concerns about the useful life assumptions for GPUs, we think this misses the bigger point that regardless of what depreciation period is used, any measure of valuation that is reliant on accounting profits (net income, EPS, P/E, etc.) is being highly distorted by the lag in D&A for that spending. Given the size of the companies at the heart of this distortion and the richness of their valuation, we believe that now more than ever investors should focus on free cash flow over accounting profits.

***For the purposes of this paper, "Big Nine" refers to Microsoft, Amazon, Meta, Google, Oracle, Apple, Nvidia, Tesla and Broadcom**

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Methodology note for ***Figures including free cash flow yield (FCF)*** *or* ***free cash flow to enterprise value yield (FCF/EV):*** *figures reflect consensus estimates of next-twelve-months (NTM) FCF in comparison to market capitalization or enterprise value (EV) for the relevant portfolio/strategy or benchmark. Stocks without data are excluded and portfolios are reweighted accordingly. Stocks with FCF/Market Cap or FCF/EV values of greater than 50% or less than -20% have been eliminated to avoid distorting overall averages.*

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