Growth investing - opportunities in the tech sector

Andrew Bascand | Harbour Asset Management | 13 May 2015 |

We are six years into a bull market in equities, and so the context of this paper is not to advocate outsized future returns to investing in technology stocks. Instead, this paper addresses the relative attraction of the technology sector.

Equity valuation and growth parameters for the market and tech sector are contrasted. Global technology sector valuations are compared with those in New Zealand and Australia. We observe a higher idiosyncratic risk and return dispersion for tech stocks and the case for an active investment approach.

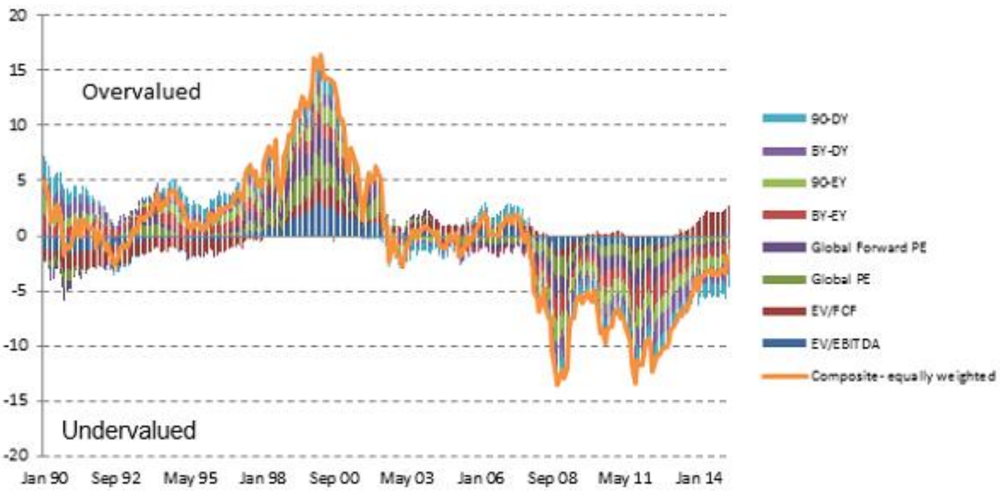
In recent years, returns in defensive yield and income sectors have exceeded those in growth sectors. For example, in the last 12 months, the return on a basket of 17 New Zealand defensive stocks has returned nearly 40% compared to a 6% return for a basket of 33 New Zealand growth and cyclical stocks. The prices of yield and income stocks are highly correlated with bond yields, which have fallen over 120 basis points in the last year.

Defensive stocks have macro drivers of return. In contrast, the performance of most growth sectors are more correlated with the prospects for individual companies' revenue and earnings growth. Lower yields on growth stocks have seen lower investment flows in recent years into those sectors. This has happened despite strong revenue growth in the technology sector.

Today, this means that the tech sector looks relatively attractive. This is a medium-term high conviction view. In aggregate, on a global basis, we find it hard to argue that equities are either expensive or cheap. However, for the purposes of this paper, readers can be either a bear or a bull on the equity market.

Certainly, using a measure of future Price-to-Earnings, many markets are trading above five- and 10-year averages. But relative to cash rates or bond yields, most equity markets are less expensive. A composite global equity valuation indicator suggests that global equities are close to a neutral valuation (Figure 1).

Figure 1: Harbour Global Composite Valuation Indicator
April 2015 (Standardised scale)



Sources: Harbour Asset Management

THE BROADER US EQUITY MARKET MAY BE EXPENSIVE

The US equity market today trades on a forward price earnings multiple of over 17.5 times, and is close to the high point of the last 10 years (Figure 2). Much of the price performance in the last three years has reflected a valuation gain, with earnings growth slowing as margins continue to reach close to peak levels. Many investors have been attracted to sectors with strong cash flows and higher yields. Overall, the US equity market is trading on about a 20% premium to the average valuation of the last 10 years, based on future Price-to-Earnings multiples.

Figure 2: Valuation of US Equities: SP 500

Sources: Harbour Asset Management, Bloomberg.

In contrast, the US technology sector is trading on only about a 5% premium valuation relative to history (Figure 3), and for the purpose of this paper, this excludes the dot.com era. This smaller valuation premium relative to the broader market seems incongruent against a much stronger track record of earnings growth, higher cash balances and higher prospective earnings growth.

Many investors still hold the perspective that tech is high volatility and high risk and that companies have short product cycles. The Tech Bubble is still a psychological factor for investors. And yet, today, pure tech makes up 20% of the broader US equity market and 13% of the global equity market. Tech sector earnings have become more diversified and more reliable, generating growth of 10.0% per annum in the last 10 years compared to the broader market growth rate of 6.5%.[1]

Figure 3: Valuation of the Technology Sector: NASDAQ

Sources: Harbour Asset Management, Bloomberg.

Today, the NASDAQ trades on a PE multiple of about 18.5 times (Figure 3). The multiple has been steady over the past two years, with recent earnings growth being reflected in price performance. Although some tech stocks may have excessive revenue and earnings expectations, it doesn't appear as if the overall is baking in excessive growth.

Stock prices generally reflect investor expectations about future earnings. This is where we think the recent preoccupation with yield has provided an investment opportunity. The tech sector stands alone in having more cash than debt. This gives the sector ample room to increase dividends as well as engage in buy backs or make accretive acquisitions.

And yet, today, the tech sector is trading on a relative multiple close to all-time lows (Figure 4). In other words, you can buy tech at the cheapest relative prices investors have observed.

Figure 4: Relative valuation NASDAQ v SP 500

Relative PE

Sources: Harbour Asset Management, Bloomberg.

A word of caution again, however - overall global equity valuations are not cheap in an absolute sense. The strength of this analysis is very much a relative view. Moreover, some tech stocks may have significant risk. This paper provides only generalised advice.

WHAT IS THE TECH SECTOR?

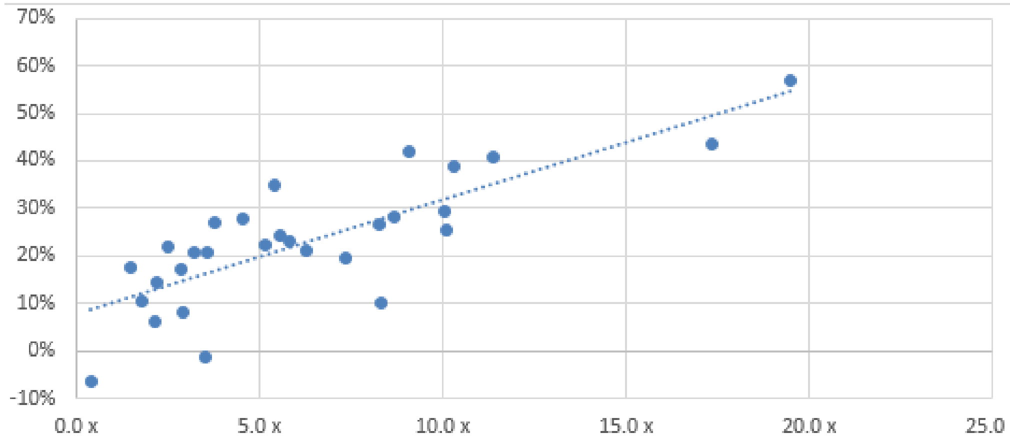
It is true that the tech sector continues to morph. Fifteen years ago, the dot.com era was characterised by eye watering valuations literally based on eye-balls. Stocks were priced according to how many page views were captured. Now, stocks listed on the NASDAQ encompass broader sectors and more diverse revenue and income models. More and more, tech companies are founded on improving productivity. And the investment cycle is ramping up, with R&D investment growth rates hitting double digits in the US in the last year. It's no longer about eyeballs![2]

Tech investment is generally disruptive, accessing revenue pools previously the domain of other sectors. A 2013 McKinsey Global Institute report "Disruptive Technologies" is a must read for investors, not just tech investors. A sample of what's on offer include the Internet of Things - networks of low-cost sensors for monitoring and automation in the home and at work; cloud technology which is reducing demand for hardware in the office and at home; advanced robotics which are improving labour productivity; next generation genomics which is providing increasingly low cost gene sequencing for individualising medical treatment; 3D printing which is bring forward production cycles across manufacturing and healthcare; and, (the author's favourite) energy storage which is rapidly changing the use of electricity grids, vehicles, and mobile life. Again, tech is no longer about eyeballs.

A core sector relevant for New Zealand tech investors is the fast growing Software as a Service (SaaS) tech companies. This sector is relevant because many Australasian tech companies have or are evolving SaaS models. In the US, in this fast-growing established tech sub-sector, investors have adopted a relatively consistent valuation approach. You pay for revenue growth. Figure 5 shows that for a sample of 29 SaaS companies in the US, the average expected revenue growth is 25% with a valuation metric of about 7.5 times revenue. Valuations rise by about one third for every 10% rise in prospective revenue growth (Figure 5).

Figure 5: Relative valuation for medium growth US tech SaaS companies.

Prospective revenue growth

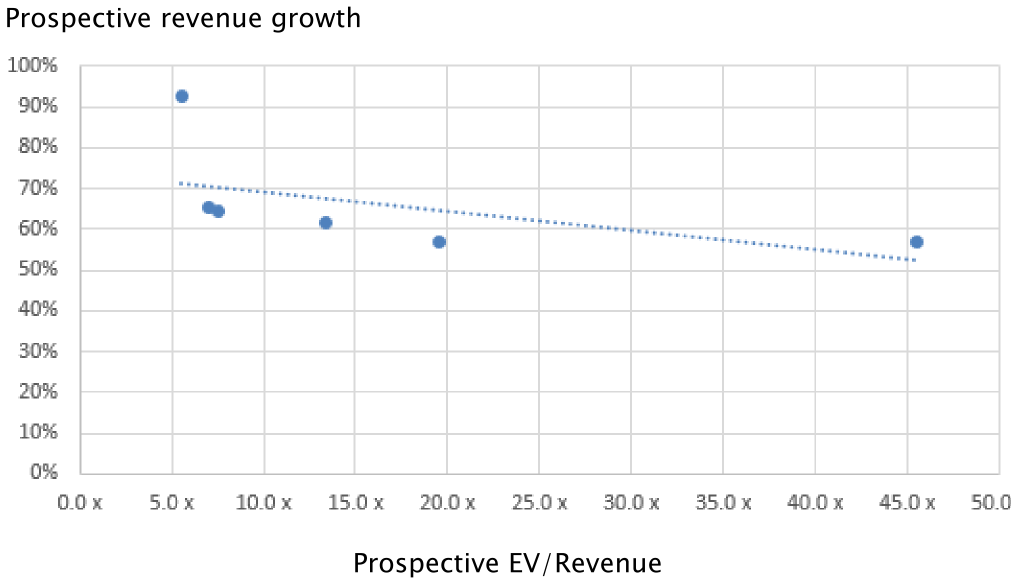


Prospective EV/Revenue

Sources: Harbour Asset Management, Macquarie, Bloomberg.

However, valuation consistency dissipates when expected growth rates exceed 50% (Figure 6). Perhaps that is because investors find very high growth rates less plausible, or perhaps the sample size is simply too small to draw strong conclusions.

Figure 6: Relative valuation for very high growth US tech SaaS companies.

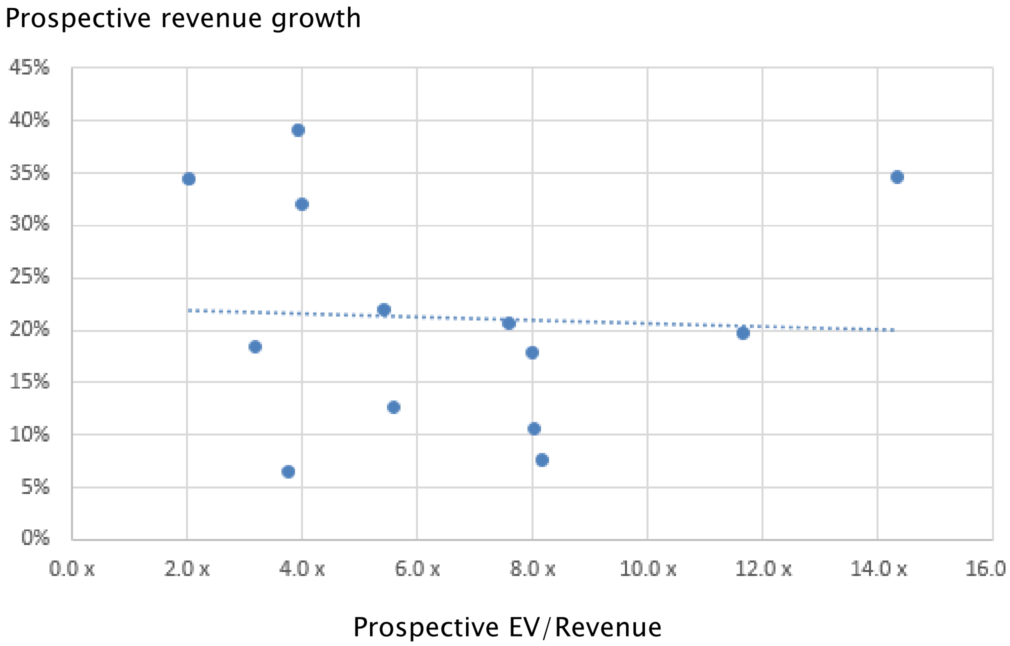


Sources: Harbour Asset Management, Macquarie, Bloomberg.

By comparison, the New Zealand and Australian listed tech sector is more limited and investors may be less sophisticated. So what can be observed with respect to valuations? In a sample of 13 companies excluding the very high growth examples (eg, eRoad and Xero), average absolute valuations per unit of growth are similar to the US experience (Figure 7). That is, valuations average about seven times revenue for 25% prospective growth. On the face of it, it appears that we operate in a global market.

However, in New Zealand and Australia, valuation dispersion in the tech sector is very high, with no real consistency in valuation relative to revenue growth (Figure 7). Some companies with high prospective growth have lower valuations than those with lower growth rates. This dispersion may create opportunities for active investors.

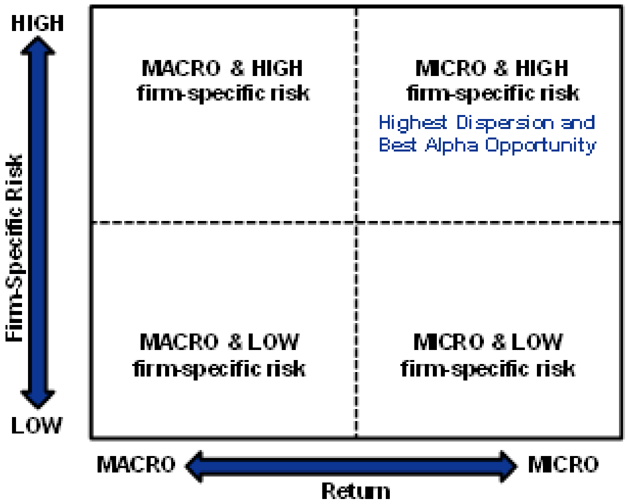
Figure 7: Relative valuation for NZ and Australian tech (ex eRoad and Xero)



Sources: Harbour Asset Management, Bloomberg.

Goldman Sachs recently developed a global framework for identifying stocks with the most attractive characteristics for active investment. The framework separates macro and micro drivers of stock returns. The intuitive placement of sectors is backed by quantitative analysis. For instance, defensive stocks have high macro risk, driven by interest rates and bond yields. Energy and resource companies also have high macro risks but these while sectors are characterised by significant macro influences, energy and resource stocks have high specific risk. As expected, the technology and healthcare sectors provide some of the highest dispersion and best alpha opportunities.

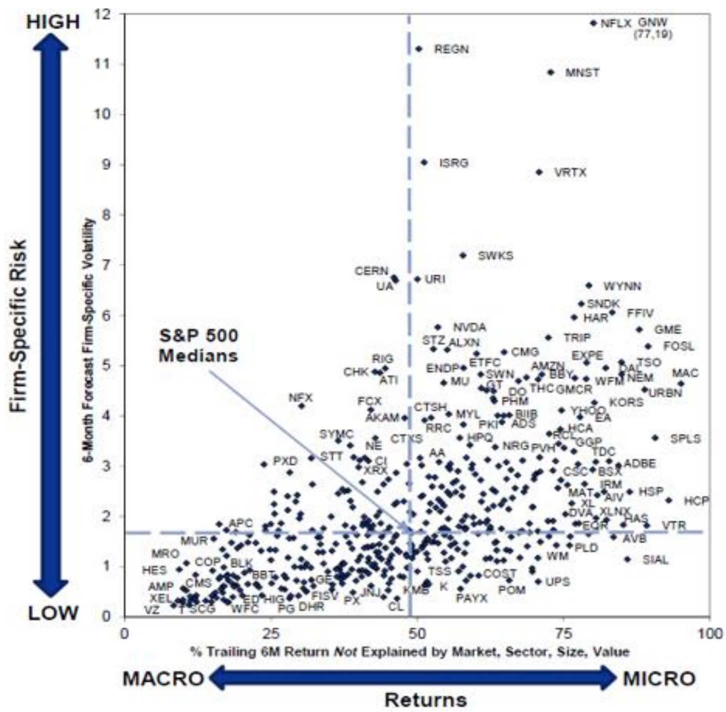
Figure 8: Framework for assessing investment opportunities



Source: Goldman Sachs

How can we see this in action? Goldman Sachs estimated factors for company specific risk and then examined the percentage of returns for each stock that is explained by macro factors as opposed to company factors. For the SP 500 in total, there is significant clustering of about half the market opportunities with low dispersion and high macro risk (Figure 9).

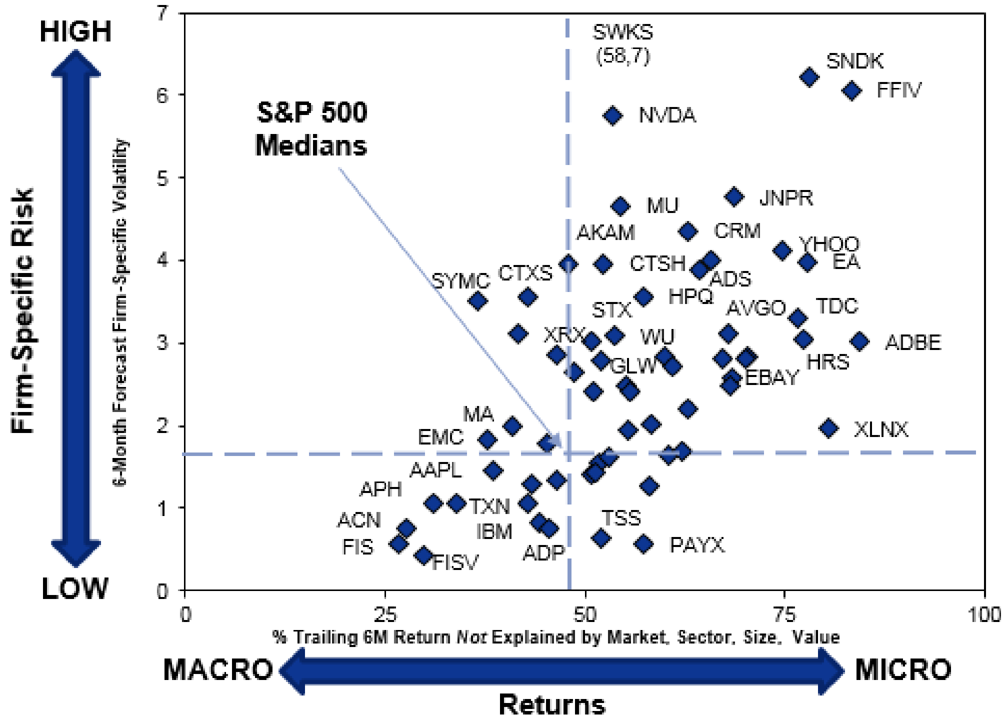
Figure 9: Overall SP 500 stocks micro versus macro influences



Sources: Goldman Sachs

In contrast, the technology sector has the highest company specific risk factors. In addition, micro influences explain more than half of returns (Figure 10). In the tech sector, only a handful of stocks have low return dispersion and relatively high macro influences, whereas all utility stocks have return profiles dominated by macro influences.

Figure 10: SP 500 tech stocks micro versus macro influences



Sources: Goldman Sachs

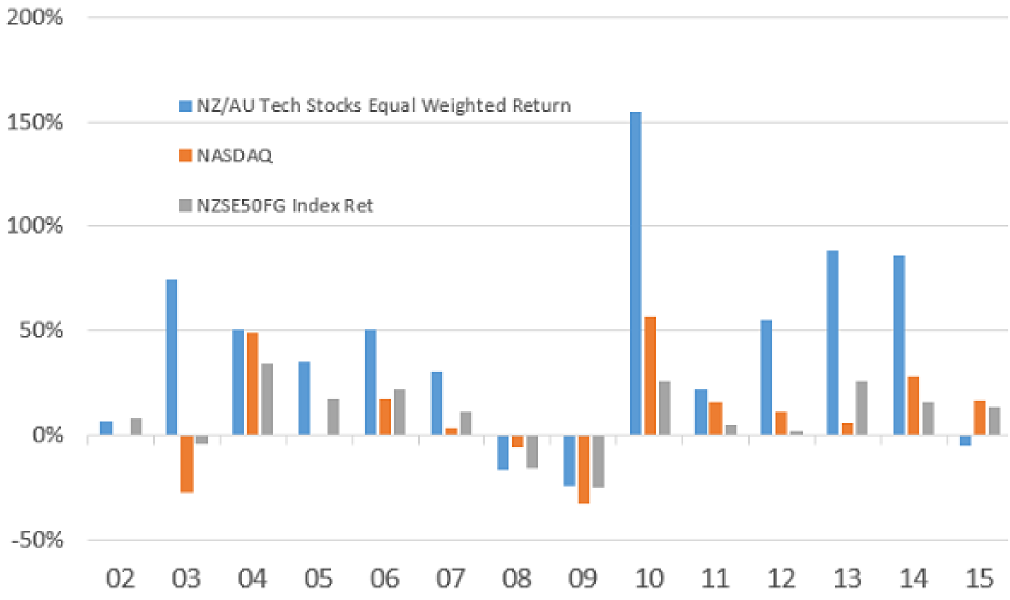
In part, these observations have probably tended to exacerbate historic investor appetite for utility stocks. A high correlation to interest rates and bond yields and low dispersion (and volatility) has increased demand for defensive sectors relative to growth sectors where returns may be more disperse and investors perceive higher risk. This recent trend may have created a medium-term relative opportunity. As noted earlier, the tech sector has never traded on relative multiples as low as today. Earnings growth for the tech sector is forecast at 8.6% per annum in the next three years against 4.6% per annum for the broader market.[1] Moreover, the M&A cycle in tech continues, with recent acquisition multiples supporting valuations.

The cash rich tech sector has the ability to lift dividends, increase buy backs and make earnings accretive acquisitions.

A final note on perceptions of risk relative to return. An equally-weighted basket of New Zealand and Australian tech stocks outperformed the NZ equity market in 11 of the last 14 years (to March), as shown in Figure 11. The same basket of stocks also outperformed the broader NASDAQ in 12 of those 14 years.

Figure 11: Tech in Australasia, the NASDAQ and the NZSE50

% total gross return



Sources: Harbour Asset Management, Macquarie, Bloomberg.

In the last year, investors have largely spurned tech stocks in Australasia, instead favouring defensive sectors.

Today, in the author's view, a basket of largely uncorrelated NZ and Australian tech stocks is valued attractively relative to the broader market. The sector carries much higher idiosyncratic risk, but that is where the combination of diversification and active management can provide attractive medium-term opportunities.

Although many investors will continue to be attracted to the stable yields available in the defensive utility sectors, several NZ and Australian tech stocks are now priced at valuations similar to the defensive sectors. And yet, these same stocks have stronger balance sheets, stronger revenue growth and – in some cases – more than 20% growth in underlying earnings.

If technology continues to gain revenue from traditional sectors, investors should consider carefully the opportunity to add to their tech sector exposures in balanced portfolios.

ENDNOTES

1. Source Strategas

2. Eyeballs referred to page views used in the dot.com era and today for advertising revenue models.

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